No. 06-1286

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| Title: | Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust, Petitioner<br>v.<br>Commissioner of Internal Revenue |
| Docketed: | March 23, 2007 |
| Lower Ct: | United States Court of Appeals for the Second Circuit |
| Case Nos.: | (05-5151-ag) |
| Decision Date: | October 18, 2006 |
| Rehearing Denied: | January 19, 2007 |

Questions Presented

| ~~~Date~~~ | ~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~ |
|---|---|
| Mar 23 2007 | Petition for a writ of certiorari filed. (Response due April 23, 2007) |
| Apr 19 2007 | Order extending time to file response to petition to and including May 23, 2007. |
| May 14 2007 | Order further extending time to file response to petition to and including May 25, 2007. |
| May 25 2007 | Brief of respondent Commissioner of Internal Revenue in opposition filed. |
| May 25 2007 | Brief amici curiae of American Bankers Association and New York Bankers Association filed. |
| Jun 4 2007 | Reply of petitioner Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust filed. |
| Jun 5 2007 | DISTRIBUTED for Conference of June 21, 2007. |
| Jun 25 2007 | Petition GRANTED. |
| Jul 10 2007 | The time within which to file the joint appendix and petitioner's brief on the merits is extended to and including August 23, 2007. |
| Aug 13 2007 | Consent to the filing of amicus briefs in support of either party or neither party received from counsel for the petitioner. |
| Aug 23 2007 | Brief amici curiae of American Bankers Association, et al. |
| Aug 23 2007 | Joint appendix filed. (Statement of costs received). |
| Aug 23 2007 | Brief of petitioner Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust filed. |
| Aug 23 2007 | Brief amicus curiae of Tax Section of the Florida Bar filed. |
| Sep 27 2007 | Extension of time within which to file respondent's brief on the merits to and including October 11, 2007. |
| Oct 11 2007 | Brief of respondent Commissioner of Internal Revenue filed. |
| Oct 12 2007 | CIRCULATED. |
| Oct 15 2007 | SET FOR ARGUMENT Tuesday, November 27, 2007. |
| Nov 2 2007 | Reply of petitioner Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust filed. (Distributed) |
| Nov 27 2007 | Argued. For petitioner: Peter J. Rubin, Washington, D.C. For respondent: Eric D. Miller, Assistant to the Solicitor General, Department of Justice, Washington, D.C. |
| Nov 30 2007 | Record received from U. S.C.A. for 2nd Circuit. (1 envelope) |
| Dec 6 2007 | Record received from U.S. Tax Court. ( 1 envelope) |
| Jan 16 2008 | Adjudged to be AFFIRMED. Roberts, C. J., delivered the opinion for a unanimous Court. |

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Supreme Court, U.S.
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IN THE

# Supreme Court of the United States

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,
*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## PETITION FOR WRIT OF CERTIORARI

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MARCH 23, 2007

## QUESTION PRESENTED

There is a deep, irreconcilable and widely noted conflict among the Second, Fourth, Sixth and Federal Circuits about the meaning of 26 U.S.C. § 67(e) – which permits trusts and estates to deduct on their income tax returns certain administrative expenses – and whether the statute permits fees for investment management and advisory services to be fully deducted on trust's and estate's income tax returns. This is an important and recurring question of federal tax law that involves deductions by trusts and estates that total in the billions of dollars annually.

The Question Presented is:

Whether 26 U.S.C. § 67(e) permits a full deduction for costs and fees for investment management and advisory services provided to trusts and estates.

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## PETITION FOR WRIT OF CERTIORARI

Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit (Petition Appendix ("App.") 1a-19a) is published at 467 F.3d 149. The decision of the Tax Court (App. 20a-30a) is published at 124 T.C. 304.

## JURISDICTION

The judgment of the Court of Appeals was entered on October 18, 2006. App. 1a. A timely Petition for Rehearing was denied on January 19, 2007. App. 31-32a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

## RELEVANT STATUTORY PROVISION

Section 67(e) of the Internal Revenue Code, 26 U.S.C. § 67(e), provides in relevant part:

> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that--
>
> > (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate. . .
>
> shall be treated as allowable in arriving at adjusted gross income.

## INTRODUCTION

This case raises an important and recurring question of federal tax law that involves billions of dollars in annual deductible expenses and on which the courts of appeals are deeply and irreconcilably divided. The question is whether

fees for investment management and advisory services, sometimes called "investment advice" fees, may be deducted in full by trusts and estates when determining their taxable income. The dispute among the Circuits about this question has been called "perhaps the most vexing controversy currently outstanding" in the world of fiduciary income taxation,[1] and it has been widely noted, not only by courts, but in the literature as well.[2]

To give a sense of the importance of the tax treatment of the income and expenses of trusts and estates, trusts and estates reported over $85 billion of gross income in the most recent year for which statistics are available, filing almost four million income tax returns that year.[3] It can be estimated that over $1 trillion in assets are held in trusts and estates in the United States.[4] Many trustees utilize the services of professionals to provide investment management and advisory services. Internal Revenue Service (IRS) statistics

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[1] Janes, *Fiduciary Administrative Expenses: How Much Is Deductible?*, 32 Est. Plan. 21, 21 (2005).

[2] See, *e.g.*, Bell and King, *Sweeping Up the Two Percent Floor:* Scott v. United States *and the Deductibility of Investment Advisory Fees*, 38 Real Prop. Prob. & Tr. J. 589, 596 (2003) (describing the "classic split among the circuits").

[3] See Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 3 (IRS 2005) (Fiduciary Income Tax Returns, Income, Deductions, and Tax Liability, by Tax Status, and Size of Gross Income, Filing Year 2004) available at http://www.irs.gov/pub/irs-soi/04fd03ts.xls.

[4] Over $1.1 trillion is held in personal trust and agency accounts alone in banks and trust companies in the United States. See FDIC, 2005 FDIC Trust Report and Table 1 (2006), available at http://www.fdic.gov/bank/individual/trust/report2005.html and http://www.fdic.gov/bank/individual/trust/table1.htm. In a recent year, decedents' gross estates valued individually at over $625,000 held in total $195.6 billion (measured at the time of the decedents' deaths). See Johnson and Mikow, *Federal Estate Tax Returns, 1998-2000* at 135 (IRS 2001), available at http://www.irs.gov/pub/irs-soi/00esart.pdf.

indicate that each year trusts and estates incur costs of several billion dollars in fees for such services.[5]

When an individual incurs such expenses, they are not fully deductible in calculating the individual's taxable income. Congress, however, has sought to provide preferential treatment for the expenses of administration and management of trusts and estates. 26 U.S.C. § 67(e) provides that:

> the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that . . . the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income.

26 U.S.C. § 67(e).

This beneficial rule for trusts and estates has two components. Its first prong requires that for an expense to be fully deductible it must have been "paid or incurred in connection with the administration of the estate or trust." Its second prong specifies that in order for that expense to be fully de-

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[5] See *IRS Tax Stats* at Table 3. The IRS does not publish data that precisely disaggregate these costs. For the most recently reported year, IRS data show a total of $5.6 billion in deductions on fiduciary income tax returns for a category known as "other deductions not subject to the two-percent floor." Id. Until the decision below was rendered, the largest component of that category was likely deductions for fees for investment advisory and management services. The data also show a total of $1.2 billion for what are called "allowable miscellaneous deductions." Under rulings of the Fourth and Federal Circuits described in more detail below, some trusts and estates categorized their fees for investment advice in that category, and, again, such fees were likely the largest single type of deduction within that category. Finally, the data show $3.9 billion deducted in that one year for trustees' and other fiduciaries' fees. Id. These fees, too, are primarily for investment advice and management. To the extent it is relevant to this case, these categories will be described more fully below.

ductible, it must also be one "which would not have been incurred if the property were not held in such trust or estate."

The Circuits are split 1-2-1 about the meaning of this second prong, and whether it permits fees for investment management and advisory services to be deducted in full by trusts and estates. "Because of the fiduciary obligations imposed on personal representatives and trustees, these conflicting decisions [of the courts of appeals] affect every trust and every estate that files an income tax return." Balter, *Second Circuit Holds Trust's Investment Advisory Fees ARE Subject to 2% Floor*, 32 Tax Mgmt. Est., Gifts & Tr. J. 136, 136 ( 2007).

The United States Court of Appeals for the Sixth Circuit has ruled that costs that "would not have been incurred if the property were not held in such trust or estate" include those costs that are imposed upon the trustee by his fiduciary duties. *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993). Consequently, it has held that investment management and advisory fees are fully deductible under § 67(e). Id. at 304-305. The United States Courts of Appeals for the Fourth and Federal Circuits have held that that statutory language covers only those costs that are not "of a type . . . commonly" or "customarily" incurred outside trusts. See *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (CAFed 2001); *Scott v. United States*, 328 F.3d 132, 139-40 (CA4 2003). Those Courts have held that under their test, such fees are not fully deductible under § 67(e).

Finally, in the decision below, the Second Circuit has advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner." App. 13a. Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits, id. 12a, the Second Circuit held that fees paid by trusts and estates for management and investment of assets are never fully deductible. Id. 19a.

This split in authority is untenable. It relates to an important and recurring problem and while it endures, the requirements upon federal taxpayers under the Internal Revenue Code vary from Circuit to Circuit. The decision below may cause the migration of trusts to, or the appointment of trustees located in, the Sixth Circuit or the Circuits where no decision on this question has been rendered in the hope that the Sixth Circuit rule will be followed in those Circuits. As this Court has long recognized, there are few areas of law in which the need for uniformity is as clear.

The financial impact of the decision below is also enormous, both in terms of the cost to the beneficiaries of trusts and estates, and to the financial services industry that provides these investment advice and management services.

Finally, this case presents an appropriate vehicle for the resolution of the split. The question presented was dispositive below and is cleanly and squarely presented. The issue has more than sufficiently percolated in the lower courts. Indeed, the Second Circuit's decision to coin a new test rather than adopting either the Sixth Circuit's approach or the interpretation of the Fourth and Federal Circuits indicates that further percolation may produce only greater conflict and confusion. Certiorari therefore should be granted.

## STATEMENT

1. The William L. Rudkin Testamentary Trust ("Trust" or "Rudkin Trust") was established in 1967 under the will of Henry A. Rudkin, Sr. ("Rudkin" or "Henry Rudkin"). Rudkin, with his wife Margaret, founded Pepperidge Farm, maker of cookies and other food products. The Trust was funded with proceeds of the 1961 sale of Pepperidge Farm to the Campbell Soup Company. The Will and its First Codicil (the "Trust Documents") state that the Trust income and principal may be distributed by the Trustees of the Trust at their discretion for the "support, comfort, and education" of any or all members of the class comprising Rudkin's son William L. Rudkin, his wife or widow, and his descendants

and their spouses. App. 35a, 45a-46a. In addition, the Trust Documents specify that the principal may be distributed by the Trustees at their discretion "to advance the best interests of such member or members [of that class] in any business venture in which such member or members may be engaged or in which such members may wish to engage." App. 45a-46a.[6] At the beginning of the tax year at issue in this case, 2000, the Trust had assets worth $2,884,542.00.

The Trust is designed to last for generations. It expires twenty-one years after the death of the last survivor of Henry Rudkin's descendants living at the time of his death (or, if it occurs earlier, upon the deaths of William L. Rudkin and all of his descendants). App. 36a. The youngest of Rudkin's descendants who were living at the time of his death, Katharine Rudkin Allsopp, is now 46 years old. If she lives to be eighty, the Trust will not expire until 2063.[7]

The Trustees must comply with certain obligations in their management of the Trust assets:

•To begin with, the Connecticut Probate Court has appointed a guardian *ad litem* to protect the interests of the unborn beneficiaries of the Trust. See *Estate of Henry A. Rudkin*, Order of the Probate Court for the District of Fairfield, Fairfield Probate Court Records, Vol. 288, p. 644 (December 21, 1970). The Trustees are required to file a detailed principal and income trust accounting with the guardian and the Probate Court every three years. See Conn. Gen. Stat. § 45a-177.

•The Trust Documents do not provide any safe harbor for the Trustees in their decisions about investing the Trust assets. Rather the Trust Documents provide that the Trustees

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[6] The Trustees are also required to distribute portions of the trust principal to any persons or organizations designated by William L. Rudkin during his life or in his will if it was duly admitted to probate (except for William L. Rudkin himself or his estate or their creditors). App. 36a.

[7] Upon the Trust's expiration, its assets will be distributed to the living descendants of William L. Rudkin, *per stirpes*. App. 36a.

may "invest and reinvest the funds . . . in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds." App. 38a.

•Further, the Trustees are subject to the Connecticut Uniform Prudent Investor Act. Conn. Gen. Stat. §§ 45a-541a to 45a-541*l*.[8] The Connecticut statute provides that "[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust." Id. § 45a-541b(a).[9] It further specifies that "[a] trustee's investment and management decisions respecting individual assets shall be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Id. § 45a-541b(b). The statute mandates the consideration by the Trustees in investing and managing of Trust assets of ten enumerated circumstances, including "the nature and estimated duration of the trust." Id. § 45a-541b(c).[10]

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[8] Since the completion of the Uniform Prudent Investor Act in 1994, versions of the uniform law have been adopted by 44 States and the District of Columbia as the standard for trust investment law. See Uniform Law Commission, A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Mar. 23, 2007) (listing States).

[9] Of course, the common-law requirement of prudence in performance of a trustee's fiduciary obligations long antedates adoption of this statute. See *Harvard College v. Amory*, 9 Pick. 446, 461 (Mass. 1830).

[10] Conn. Gen. Stat. §§45a-541b(c) provides in full:

> Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) General economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions, strategies and distributions; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enter-

**2.** In order to comply with these obligations, the Trustees engaged Warfield Associates, Inc., ("Warfield"), an SEC registered investment advisor in New York, to manage the Trust assets.[11] Warfield charged the Trust an annual fee of 0.8% of Trust assets, billed quarterly. During 2000, Warfield charged, and the Trustees paid, quarterly fees totaling $22,241.31 for Warfield's services.

Trusts and estates, like individuals, must pay a tax upon their "taxable income." See 26 U.S.C. § 1. Trusts and estates must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, called a fiduciary income tax return, whereas individuals must file the more well-known Form 1040.

On the Trust's Form 1041, the Trustees included a deduction for this full amount of Warfield's fees in calculating the Trust's taxable income. Taxable income for both individuals and trusts is derived, first, by taking "gross income," defined as "all income from whatever source derived," 26 U.S.C. § 61(a), and deducting in full certain expenses that are enumerated by statute (called "above-the-line" deductions) in order to arrive at a figure for "adjusted gross income." See 26 U.S.C. § 62(a). Taxable income is calculated by subtracting from "adjusted gross income" other deductions that are also enumerated by statute (these are called

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prises, tangible and intangible personal property and real property; (5) the expected total return from income and the appreciation of capital; (6) related trusts and other income and resources of the beneficiaries; (7) needs for liquidity, for regularity of income and for preservation or appreciation of capital; (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries; (9) the size of the portfolio; and (10) the nature and estimated duration of the trust.

[11] The Trust Documents provide that the Trustees may "employ such agents, experts and counsel as they may deem advisable in connection with the administration and management" of the Trust. App. 41a. This delegation is expressly permitted by the Connecticut statute, see Conn. Gen. Stat. § 45a-541i(a).

"itemized" or "below-the-line" deductions). See 26 U.S.C. § 67(b) and Code sections cited therein. A subset of these itemized deductions, called "miscellaneous itemized deductions," however, has since the adoption of the Tax Reform Act of 1986 ("the 1986 Act") been deductible only to the extent that their aggregate "exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a). These miscellaneous itemized deductions are, in other words, no longer fully deductible; in common parlance, the 1986 Act imposed a "two percent floor" on their deductibility.[12]

Individuals may not ordinarily deduct investment management and advisory fees in full from their gross income in order to calculate their adjusted gross income. Rather, under Treasury Regulations such fees are treated as "miscellaneous itemized deductions" that are subject to the two-percent floor. See Temp. Treas. Regs. § 1.67-1T(a)(1)(ii), 53 Fed. Reg. 9870, 9875 (Mar. 28, 1988); 26 CFR § 1.212-1(g); see also 26 U.S.C. § 212.

The Tax Code, however, has long given preferential treatment to the expenses incurred by trustees for the administration and management of trusts and estates, and in the same Section of the Code where it imposed the two-percent floor, Congress also provided in the 1986 Act that:

> the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that . . . the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which

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[12] Congress limited the deductibility of these miscellaneous itemized deductions to relieve individual taxpayers and the IRS of the complexity and recordkeeping burdens that resulted when these deductions were allowed in full, and to prevent individuals from erroneously deducting expenses with "the characteristics of voluntary personal expenses" that lacked "sufficient business or investment purpose," for example, erroneous deductions for home office expenses, magazine subscriptions and safe deposit services. See H. Rep. No. 99-426 at 109-110 & n.8; S. Rep. No. 99-313 at 78-79 & n.18.

> would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income.

26 U.S.C. § 67(e).[13] The Trustees deducted the fees paid to Warfield in full because they "would not have been incurred if the property were not held" in the Rudkin Trust.[14]

**3.** Respondent Commissioner disallowed this full deduction, permitting the Trust to deduct these fees only to the extent that they exceeded two percent of the Trust's adjusted gross income. He issued a Notice of Deficiency to the Trust in the amount of $4,448.[15]

Petitioner Trustee Michael J. Knight petitioned the Tax Court for a redetermination of deficiency. See 26 U.S.C. §§ 6212, 6213, 6214 and 7442. The Tax Court sustained the Commissioner's position. The court recognized that there is "a split in authority" among the courts of appeals on the issue of the deductibility of the costs of investment advice under § 67(e). It chose to follow its own previous decision in *O'Neill v. Commissioner*, 98 T.C. 227 (1992), even though that decision was reversed by the Sixth Circuit. See *O'Neill v. Commissioner*, 994 F.2d 302 (CA6 1993), rev'g 98 T.C.

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[13] The parties agree that fees paid for investment management and advisory services are "costs which are paid or incurred in connection with the administration of the estate or trust" within the meaning of the statute. See App. 6a; *Ungermann Trust v. Commissioner*, 89 T.C. 1131 (1983) (a very broad range of costs are included within the universe of administrative costs covered by this statutory language).

[14] The Trust listed these fees on a line on Form 1041, entitled "Other deductions not subject to the 2% floor." The Trust listed no miscellaneous itemized deductions subject to the 2% floor on the Form 1041 line for such items.

[15] The parties subsequently discovered an error in the calculation of adjusted gross income in the Trust's return, and they agree the correct number is $613,263, rather than the $624,816 listed on the return. The amount of the deficiency, though, was ultimately not altered by this correction. See App. 3a.

227 (1992).[16] As the Tax Court described, in *O'Neill* it held that

> the thrust of the language of section 67(e) is that only those costs which are unique to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth at section 67(a). . . . Individual investors routinely incur costs for investment advice as an integral part of their investment activities. Consequently, it cannot be argued that such costs are somehow unique to the administration of an estate or trust . . . .

App. 26a-27a (quoting *O'Neill*, 98 T.C. at 230-231).

The Tax Court recognized that it had been reversed in *O'Neill* by the Sixth Circuit, which found that investment advice fees were fully deductible under § 67(e), see id. 27a, but noted that the decisions of the Federal Circuit in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (CAFed 2001), and the Fourth Circuit in *Scott v. United States*, 328 F.3d 132 (CA4 2003), "diverged from the position taken by the Court of Appeals for the Sixth Circuit." Id. "Having reviewed our initial construction of section 67(e)," the Tax Court concluded, "and the ensuing judicial developments detailed above, this Court concludes that the interpretation set forth in [the Tax Court decision in *O'Neill*] and expressed by the Courts of Appeals in [*Scott*] and [*Mellon Bank*] remains sound." App. 29a.

**4.** Petitioner appealed to the Second Circuit. Before that court, the Commissioner conceded that "There is currently a split in the circuits regarding whether fees paid by trusts to

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[16] The Tax Court deems itself bound to follow the decisions of a Circuit Court of Appeals only when an appeal in the case before it lies to the same court of appeals. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970). In cases in which the taxpayer is not a corporation, appeals from the Tax Court are taken to the Circuit in which the taxpayer legally resides. 26 U.S.C. § 7482(b)(1).

outside investment advisors are subject to the 2% floor." Brief for Appellee ("Gov't. CA2 Br.") at 3, *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (CA2 2006). The Commissioner argued that the court of appeals should reject the Sixth Circuit decision in *O'Neill*, and follow the decisions of the Fourth Circuit in *Scott* and the Federal Circuit in *Mellon Bank*. Id. 3-4, 22-24.

A two-judge panel of the Second Circuit affirmed, but on reasoning that differed from that of the Tax Court.[17] In an opinion written by Judge Sotomayor and joined by Judge Hall, the Second Circuit declined to follow either the Sixth Circuit or the Fourth and Federal Circuits.

The court began by canvassing "[t]he Circuit Split" on the question before it. App. 7a-9a. It determined that the Sixth Circuit had held that § 67(e) permitted a full deduction for costs caused by a trustee's fiduciary obligations, App. 7a (citing *O'Neill*, 994 F.2d at 304), and that the Fourth and Federal Circuits had held that only costs "customarily" or "commonly" incurred by individuals were fully deductible. Id. 7a-9a (citing *Mellon Bank*, 265 F.3d at 1280-81 and *Scott*, 328 F.3d at 139-40).

The Second Circuit then rejected each of the interpretations put forward by its sister Circuits. Despite the statutory phrase describing costs "which would not have been incurred if the property were not held in such trust or estate," the court concluded that "nothing in the statute indicates the Congress intended to make applicability of the deduction dependent on what costs are peculiarly incurred by a specific trust." App. 13a. Rather, the court concluded that the "plain meaning" of that phrase "excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust." App. 11a (emphasis in original). "We . . . hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs

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[17] Judge Feinberg, who was originally on the panel, recused himself after oral argument. See App. 2a n.*.

that could not have been incurred by an individual property owner." App. 13a.

Applying this test, the court ruled, contrary to the Sixth Circuit, that

> the fact that investment-advice fees are subject to the two-percent floor under regulations applicable to individual taxpayers proves the fees to be a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust. By contrast, costs that individuals are incapable of incurring, like 'fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns,' *Scott*, 328 F.3d at 140, are fully deductible.

App. 12a. The court also made clear that it "disagree[d]" with the Federal and Fourth Circuits, stating that it was adopting a "more restrictive" reading of the statute than they had. App. 12a.[18]

The court asserted that even if the meaning of the statute were not plain, "canons of statutory interpretation favor[ed]" its conclusion because "when the statute is ambiguous, we resolve interpretive disputes as to the availability of a tax deduction in favor of the government." App. 14a. Finally, the court asserted that, because it had found the language of

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[18] In reaching its conclusion about the meaning of the statute, the court expressly declined to rely upon legislative history upon which the Federal Circuit had relied, noting that it "predate[d] the introduction of § 67(e)(1)'s second clause." App. 15a n.4; cf. *Mellon Bank*, 265 F.3d at 1281. It also "did not adopt the Federal and Fourth Circuit's view" that reading the statute to permit the deduction of investment advice fees would render that second clause superfluous because it would mean that all administrative costs were fully deductible. App.18a-19a n.7. See *infra* at 24-25 & n.24.

the statute unambiguous, it did not need to address its legislative history. But it asserted that, in any event, nothing in that legislative history "supports the Trust's proposed interpretation of the statute . . . or provides any reason to depart from our reading of the statute's meaning." App. 15a.

**5.** The court of appeals denied rehearing and rehearing en banc. App. 31a-32a. This Petition followed.

## REASONS FOR GRANTING THE PETITION

There is a deep, untenable and well-recognized division among the Circuits concerning the meaning of 26 U.S.C. § 67(e). It is a recurring question of enormous practical importance and financial consequence, and this case presents an ideal vehicle for its resolution.

### I. THERE IS AN ACKNOWLEDGED, IRRECONCILABLE, AND UNTENABLE DIVISION AMONG THE CIRCUITS ABOUT THE DEDUCTIBILITY BY TRUSTS AND ESTATES UNDER 26 U.S.C. § 67(e) OF FEES FOR INVESTMENT MANAGEMENT AND ADVISORY SERVICES.

#### A. The Circuits Are in Acknowledged and Irreconcilable Conflict Regarding the Deductibility of Expenses by Trusts and Estates Under § 67(e).

##### 1. The Sixth Circuit.

The Sixth Circuit holds that fees for investment advice and management services are fully deductible by trusts and estates since they are incurred because of the trustees' fiduciary responsibilities. In *O'Neill v. Commissioner*, 994 F. 2d 302, 304 (CA6 1993), the court addressed a trust the trustees of which, themselves having no expert knowledge in the investment of large sums of money, had hired an investment advisor to manage and invest the trust's assets. There the court held that "investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the" two-percent floor. Id. at 304. The court reasoned that because the fees had been caused by the fiduci-

ary duties of the trustees, they "would not have been incurred if the property had not been held in trust:"

> A trustee is charged with the responsibility to invest and manage trust assets as a "prudent investor" would manage his own assets. . . . Where a trustee lacks experience in investment matters, professional assistance may be warranted. The trustees here lacked experience in investing and managing large sums of money and, therefore, sought the assistance of an investment advisor. . . . [T]he investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees.

Id.[19]

**2. The Fourth and Federal Circuits.**

The Fourth Circuit and the Federal Circuit reject the Sixth Circuit's position and hold that § 67(e) does not permit the full deduction of fees for investment management and advice by trusts and estates because they are expenses "of a type . . . commonly" or "customarily" incurred outside trusts. See *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1280-1281 (CAFed 2001); *Scott v. United States*, 328 F.3d 132, 139-140 (CA4 2003).

In *Mellon Bank*, the Federal Circuit held that fees for investment advice were subject to the two percent floor under the "plain meaning" of the statute. The court reasoned that "[a]ll expenses resulting from the fiduciary obligations of the trustee" satisfy the first prong of § 67(e), *i.e.*, that they are all "costs which are paid or incurred in connection with the administration of the estate or trust." Id. at 1280. The Com-

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[19] Fiduciaries, the court went on "uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." Id. They differ in this regard, the court noted from individual investors who "are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." Id.

missioner conceded, as he did in this case, that "trustee fees are fully deductible." Id. at 1279. Appellant Mellon Bank argued that "[s]ervices delegated by the trustee remain subject to fiduciary standards and are fiduciary services under governing law," and that therefore payments for such services, too, were fully deductible. Id.

The Federal Circuit reasoned that if this were correct "all expenses incurred by a trustee in connection with the administration of a trust would be fully deductible." Id. at 1280. This, the court concluded, would read out of the statute the "second prong" of § 67(e) – the requirement that only administrative costs that "would not have been incurred if the property were not held in such trust or estate" are fully deductible. Id.

In an attempt to craft an interpretation that would "give full effect" to the statute and not render any of its language superfluous, the court asserted that the second prong of § 67(e) "focus[ed]" on "the type of costs" at issue. Id. at 1281. It concluded that "the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." Id.

> Investment advice and management fees are commonly incurred outside of trusts. An individual taxpayer, not bound by a fiduciary duty, is likely to incur these expenses when managing a large sum of money. Therefore, these costs are not exempt under section 67(e)(1) and are required to meet the two percent floor of section 67(a).

Id.

The *Mellon Bank* decision was followed by the Fourth Circuit in *Scott*. Noting that "[o]ur sister circuits have split over the proper resolution of the legal issue here," 328 F.3d at 135, the Fourth Circuit concluded "we find ourselves in agreement with the Federal Circuit's reasoning in *Mellon Bank*, and thus render a decision at odds with the Sixth Cir-

cuit's holding in *O'Neill*," the analysis in which, the court concluded, "contains a fatal flaw." Id. at 140.

The Fourth Circuit concluded that the language of the statute was "clear and unambiguous." Id. at 139. It stated that "[t]he verb 'would' in the context of § 67(e)(1) expresses concepts such as custom, habit, natural disposition, or probability." Id. at 139 (citing Webster's Third New International Dictionary 481 (1976) and American Heritage Dictionary of the English Language 2042, 2059 (3d ed. 1992)).

> Thus, "the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Mellon Bank*, 265 F.3d at 1280-81; *see also Mellon Bank, N.A. v. United States*, 47 Fed. Cl. 186, 188-89 (Fed. Cl. 2000). Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers.

Id. at 139-140.

Applying this test, the court asserted that "investment-advice fees are commonly incurred outside the context of trust administration," and held the fees not deductible. Id. at 140. The court concluded that "holding that a trust's investment-advice fees were fully deductible" would "render meaningless the second requirement of § 67(e). . . . To give effect to this limitation, we must hold that the investment-advice fees incurred by the Trust do not qualify for the exception created by § 67(e). Rather, they are subject to the 2% floor established by § 67(a)." Id.

**3. The Second Circuit.**

Finally, the Second Circuit has now rejected the positions of the Fourth, Federal and Sixth Circuits, holding that fees for investment management and advisory services are not deductible by trusts and estates under § 67(e) regardless of

how "commonly" they are incurred outside of trusts and estates, because they are costs of a type that "could be" incurred by an individual taxpayer. App. 11a.

The court below explicitly acknowledged the split among the Circuits. App. 7a-9a. It noted that the Sixth Circuit had "held that 'the investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the base of two percent of adjusted gross income.'" App. 7a (quoting *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993)). The Sixth Circuit's *O'Neill* decision, the Second Circuit said, "established the rule that a trust's costs attributable to the trustee's fiduciary duty, and not required outside the administration of trusts, fall within the § 67(e)(1) exception and are therefore fully deductible." Id.

The Federal Circuit, the court went on, "rejected this reasoning." Id. In *Mellon Bank*, the Second Circuit explained, the Federal Circuit held that the statute "'treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts,'" and concluded that "because '[i]nvestment advice and management fees are commonly incurred outside of trusts,'" they are not fully deductible when incurred by trusts, but are subject to the two-percent floor. Id. 8a (quoting *Mellon Bank*, 265 F.3d at 1281).

Finally, the court below recounted, the Fourth Circuit had held that "trust-related administrative expenses" are not fully deductible "if they constitute expenses commonly incurred by individual taxpayers," concluding "that because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the two-percent floor." Id. (quoting *Scott*, 328 F.3d at 139-40).

The Second Circuit then rejected both the rule articulated by the Sixth Circuit in *O'Neill*, and that adopted by the Fourth and Federal Circuits in *Scott* and *Mellon Bank*. After concluding that "the second prong of § 67(e)(1) does not ask

whether the costs at issue . . . are incurred as a result of a particular trustee's fiduciary duty," id. 11a, the court held "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner," id. 13a, and that fees for investment advice therefore were not fully deductible. And it noted explicitly its disagreement not only with the Sixth Circuit, but with the Federal and Fourth Circuits as well:

> We . . . join the Federal and Fourth Circuits in holding that § 67(e)(1) does not exempt from § 67(a)'s two-percent floor investment-advice fees incurred by trusts. We disagree, however, with their statement that costs 'not *customarily* incurred outside of trusts' are the ones not subject to the floor, *Mellon Bank*, 265 F.3d at 1281 (emphasis added); *Scott*, 328 F.3d at 139-40 (citing *Mellon Bank* and stating that § 67(e)(1) subjects 'expenses *commonly* incurred by individual taxpayers' to the two-percent floor (emphasis added)), because. . . we believe § 67(e)(1) is more restrictive than that.

Id. 12a.

**B. The Conflict Among the Circuits on this Issue Is Untenable and Presents Particularly Serious Problems for the Administration of the Revenue Law.**

This split among the Circuits is untenable. This Court has long recognized the special need for uniform rules with respect to federal taxation. See, *e.g.*, *Commissioner v. Bilder*, 369 U.S. 499, 501 (1962) (Harlan, J.) (need for a uniform rule about a specific deduction in the face of division among the courts of appeals warrants grant of certiorari). Here the difficulty with the conflict is exacerbated both by the nature of the fees at issue and the scope of the jurisdiction of the various courts of appeals.

While this Circuit conflict endures, taxpayers in identical circumstances living in different Circuits will be subject to

different federal tax laws and will face different federal tax obligations. Tax Court appeals lie to the court of appeals for the Circuit in which the taxpayer, the trustee in these cases, has legal residence. See 26 U.S.C. § 7482(b)(1). Further, until the legal issue in this case is resolved, this recurring question will generate continuing disputes in Circuits that have not yet ruled on the issue. Treasury Regulations provide that there is no penalty for taking a position in one's tax return, even one that is not ultimately sustained, so long as there is "substantial authority" for that position. See 26 CFR § 1.6662-4(a), (d). Under those regulations, the Sixth Circuit's *O'Neill* case provides substantial authority for the proposition that trusts and estates may deduct in full fees for investment advice and management, notwithstanding the decisions of the Second, Fourth and Federal Circuits. Thus, despite the Commissioner's position on this issue, trustees in the Circuits that have not ruled on this issue are likely to continue to treat these fees as deductible in full, resulting in more enforcement, litigation, and uncertainty costs. See, *e.g.*, Levin, *Limitation on Deductions for Trusts: What Should a Trustee Do?* ("Levin"), 111 Tax Notes 445, 445-447 (Apr. 24, 2006) (urging that trustees in these Circuits should take this deduction in full).

There is thus also a substantial risk of funds migrating to the Sixth Circuit from the Second Circuit in light of the decision below, or of trusts seeking to add trustees not resident in the Circuits that have rendered unfavorable decisions. Indeed, the single largest holder of trust assets in New York[20] has already advised its customers in the wake of the decision below that, while investment advice fees will be subject to the two-percent floor if that bank is the sole trustee, "if there are any co-trustees who reside outside the Second, Fourth or Federal Circuits, we ask that for 2006 you do not apply the 2% limitation if there are any applicable expenses." Letter

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[20] See FDIC, 2005 FDIC Trust Report, Table 4 (2006), available at http://www.fdic.gov/bank/individual/trust/table4.htm.

of A. Dean Theiss, Jr., Vice-President & Manager Fiduciary Specialized Services, JPMorgan Private Banking, JPMorgan Chase & Co., February 21, 2007, reprinted at App. 49a-52a.

## II. THIS RECURRING ISSUE IS ONE OF FUNDAMENTAL IMPORTANCE TO TRUST BENEFICIARIES AND THE FINANCIAL SERVICES INDUSTRY.

The magnitude of this issue and its practical importance reinforce the conclusion that certiorari is warranted. As described above, fees incurred by trustees for investment advice and management can be estimated to total in the billions of dollars each year. The defining feature of a trust (or an estate), of course, is its division of title to the property into separate legal and equitable interests. The legal interest is held by the trustee, but the equitable interest is held by the beneficiaries. And while these fees are paid by the trustees, those most directly harmed are trust and estate beneficiaries of all kinds, be they an individual's surviving family members, as in this case, individuals unable to manage their own affairs, through age, disability or the like, or, in the case of estates, beneficiaries named in a will.

Subjecting these fees to the two-percent floor increases the tax liability of a trust or estate. Ultimately this reduces the size of the trust corpus – and its future earnings over time. And, if the ruling below is allowed to stand, trust assets will be reduced not just once, but annually. Cf. Janes, *Fiduciary Administrative Expenses: How Much Is Deductible?*, 32 Est. Plan. 21, 22 (2005) (noting that if these fees are subject to the two percent floor there can be "a sizable loss of deductions"). The resolution of this question therefore is of profound significance to current and potential trust settlors and beneficiaries – and, in light of the amount of tax revenue involved, to the United States.

The financial services industry, too, is seriously affected by the legal issue in this case. The split in authority that was deepened by the decision below may have serious consequences for the financial services industry in New York, as

trustees, settlors and beneficiaries seek ways to avoid the two-percent floor that may include abandonment of New York-based trustees in favor of trustees located elsewhere in the country. Financial services companies are typically chosen both to serve as trustees and to provide management and advisory services for those trusts; individual trustees in the Second Circuit also typically obtain investment management and advisory services from financial services companies in the Circuit, particularly in New York.

Even apart from the incentives created by the lack of nationwide uniformity, the decision below could have serious consequences for this sector of the economy. Under the Second Circuit's decision, trustees will have an interest in attempting to fulfill their fiduciary responsibilities of prudent investment without incurring investment management and advice fees subject to the two-percent floor. This would be bad for the financial services industry and for those for whom trust assets are held.

Some, particularly smaller trusts, may take their assets out of management and attempt to invest them in mutual funds, the costs of which are always deductible. See 26 U.S.C. § 67(c)(2). Others may try to use brokers, who typically charge nothing for their advice, but only commissions for purchases and sales, which are included in the cost basis for securities and deducted from the gain upon sale such that they are effectively excluded from taxable income, see 26 CFR § 1.263(a)-2(e). Many will also likely seek trustees who are themselves skilled in investment, so that no separate investment advice and management fee need be incurred. This is an approach that has been described repeatedly in the literature.[21] The Commissioner takes the position that under

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[21] See, *e.g.*, Satchit, *Estates, Trusts & Gifts: Trusts, Investment Advisory Fees and the 2% Floor*, Tax Adviser, Feb. 2004 at 87, 88; Hohos, *Fees Paid By Trustees For Investment Strategy Advice and Management Services are not Deductible Under Section 67(e)(1):* Mellon Bank, N.A. v. United States, 54 Tax Law. 693, 699 (2001).

§ 67(e) "[t]rustee's fees" are not subject to the two-percent floor. See Gov't. CA2 Br. at 24. Trustees, though, are paid primarily to manage trust assets, something reflected in the fact that such fiduciary fees totaled $3.9 billion in 2004, the last year for which data is available.[22] The concern of the financial services industry about the decision below can be seen in the steps already being taken by some banks to address that decision while retaining their trust clients. See App. 49a-51a.

## III. THE READING GIVEN THE STATUTE BY THE COURT BELOW IS CLEARLY IN ERROR.

### A. The Second Circuit's Interpretation of the Statutory Language is in Error; Under its Most Natural Reading, the Statute Permits the Deduction in Full of Fees for Investment Management and Advisory Services.

1. While certiorari thus should be granted regardless of what position on the merits is correct, in fact, the construction given the statute below is clearly in error, and requires reversal. Section 67(e) provides that the trust's administrative expenses are fully deductible so long as they "*would* not have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e) (emphasis added). The Second Circuit held that "the plain meaning of the statute permits a trust to take a full deduction only for those costs that *could*

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[22] See *IRS Tax Stats* at Table 3 (IRS 2005), available at http://www.irs.gov/pub/irs-soi/04fd03ts.xls. The Commissioner has suggested that he has "authority to require trustees to 'unbundle' their fees" presumably to determine what portion of them might be attributable to investment management and advice. See Gov't. CA2 Br. at 56. The Commissioner, however, has never issued regulations requiring disaggregation of such fees, despite his longstanding position that fees for investment advice and management are subject to the two-percent floor. The burden upon the IRS and the taxpayers of evaluating the proportion of such fees attributable to investment advice and management in each case, including the enormous difficulty that would be involved in auditing this question, is another substantial cost that would be imposed if the statute were consistently read as the Commissioner urges.

not have been incurred by an individual property owner." App. 13a (emphasis added).

This is wrong and the court's reasoning cannot withstand scrutiny. Asking whether something "would not" have been incurred is not the same as asking whether it "could not" have been incurred. Not even the Commissioner urged this construction upon the court below. See Gov't. CA2 Br. at 22-24 (urging the court to adopt the *Mellon Bank/Scott* reading of the statute). The Second Circuit's construction is plainly in error.

The best reading of the statute simply tracks its language: "[C]osts which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable." 26 U.S.C. § 67(e). The fees at issue here, for advice on how to invest Rudkin Trust assets consistent with the purposes of that trust "would not have been incurred if the property were not held in such trust." That is the end of the matter. These fees, therefore, should be fully deductible.

**2.** This reading does not render the second prong of § 67(e) superfluous. There are, indeed, administrative costs that a trustee can incur that would have been incurred even if the property were not held in the trust at issue. The primary example of these are administrative costs that are passed through to the trust from so-called pass-through entities. Pass-through entities include partnerships and S corporations. Such entities do not pay income tax themselves, but "pass through" their income, deductions and credits, which are reported by their ultimate owners. See, *e.g.*, 26 U.S.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.")

Pass-through entities can be abused because the tax law may allow them to claim on their own tax returns deductions

in full that would, if taken directly by their owners, have been subject to the two-percent floor. These deductions would be passed through to their owners on the form used by the pass-through entity to report to its owners their share of income and deductions.

The 1986 Act included a provision to restrict the ability of individuals to indirectly deduct expenses of pass-through entities in this way to avoid the two-percent floor. See 26 U.S.C. § 67(c).[23] The second prong of § 67(e) effects a parallel restriction on trusts and estates. If a trust were a partner or shareholder in a pass-through entity, that entity could incur expenses in its administration, and pass them through to the trust, reporting them as deductions on the tax form sent to the trust. The trust could then record them as administrative expenses on its tax return. But in most circumstances these expenses "would . . . have been incurred" regardless of whether the interest in the pass-through entity was or was not "held in such trust or estate." When an individual owns an interest in a pass-through entity, these costs are subject to the two-percent floor. The second prong of § 67(e) makes clear that when a trust owns an interest in a pass-through entity, these costs may also be subject to the two-percent floor. Indeed, the legislative history of that second prong confirms that this was its primary purpose. See H.R. Conf. Rep. No. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.[24]

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[23] 26 U.S.C. § 67(c) provides in relevant part: "The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection."

[24] In both the original House and Senate versions of the bill, § 67(e) did not contain a second prong. In both versions, it read simply "For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that deductions for costs paid or incurred in connection with the admini-

**B. There is No Basis for Reading the Statute as the Fourth and Federal Circuits Have.**

In the absence of a superfluity problem, there is no basis for adopting the *Mellon Bank* court's reading of § 67(e) as asking about different "types" of expenses. The statute does not ask if expenses are like those that are incurred by individuals. It asks about the specific expenses incurred by the particular trust that is claiming the deduction: Are they "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate"?

And, while the *Scott* court is correct that the word "would" is sometimes used "to expres[s] concepts such as custom, habit, natural disposition or probability," 328 F.3d at

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stration of the estate or trust shall be treated as allowable in arriving at adjusted gross income." See H.R. 3838 (99th Cong., 1st Sess, Dec. 17, 1985) (House version); H.R. 3838 (99th Cong. 2d Sess., May 29, 1986) (Senate version). The second prong was added in the Conference Committee. Its legislative history, therefore, lies solely in the Conference Report, which makes clear that Congress had in mind preventing estates and trusts from indirectly deducting administrative costs of pass-through entities:

> Pursuant to Treasury regulations, the floor is to apply with respect to indirect deductions through pass-through entities . . . In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid and incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.

H.R. Conf. Rep. No. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.

139, that is obviously not the sense in which it is used here. See, *e.g.*, Merriam-Webster Collegiate Dictionary 1445 (11th ed. 2003) (giving as an example of the use of the word "would" to "express custom or habitual action" the phrase "we would meet often for lunch"); Webster's New International Dictionary of the English Language 2955 (2d ed. 1956) (describing the use of "would" to describe custom or habit as a "special use"). The statute is not asking about what happened in the past customarily or habitually. It is asking concretely with respect to "the" particular trust or estate whether the administrative expense at issue is one "which would not have been incurred if the property were not held in such trust or estate."

Further, determining what expenses are "customarily" or "commonly" incurred by individuals opens up a judicially unmanageable inquiry that Congress could not have intended. Are management fees "commonly incurred" by individuals? Common experience suggests that they are not. To begin with, even moderately wealthy individuals rarely hire investment management professionals to manage their portfolios. Providers of such services ordinarily won't even accept clients with assets below some high threshold. And most individuals invest primarily in mutual funds or in individual stocks that they pick themselves or that are recommended by their broker, paying only commissions and not advisory fees. Petitioner argued below that, even if the court adopted the customary-individual-cost test articulated in *Scott* and *Mellon Bank*, fees for investment management and advice do not meet it. The Second Circuit did not reach this alternative argument for reversal after it rejected the position taken by the Fourth and Federal Circuits.

More broadly, if determining whether a cost "would not have been incurred if the property were not held in such trust or estate" requires examining what an individual with such property would "commonly" or "customarily" have done, the answer will differ from case to case depending, among other things, on the amount and type of the property held in trust.

Nor is it at all clear upon what evidence a court could hope to rely in answering the question what costs individuals "customarily" incur in the myriad variable fact patterns that will be presented by different trusts.

Nor does the Commissioner even apply this "common" or "customary" costs approach consistently. The Commissioner concedes, for example, that costs for "the preparation of fiduciary income tax returns" are fully deductible under § 67(e). See Gov't. CA2 Br. at 24. The courts of appeals that have sustained his position about investment management and advisory fees have all agreed with this reading of the statute. See, *e.g.*, App. 12a; *Scott*, 328 F.3d at 140. Yet tax return preparation fees are costs of a "type" commonly incurred by individual taxpayers in the millions every tax season. "Income tax return preparation fees . . . are not unique to trusts or estates." Levin, 111 Tax Notes at 453. Regardless of who owned the property held in a trust, a tax return reporting income it has generated would have to be prepared and filed.

The Commissioner concedes, too, that "[t]rustee's fees" are fully deductible, see *supra* at 22-23, a conclusion with which the courts of appeals that have sustained his position have also agreed. *E.g.*, App. 12a. But again, trustees are paid primarily to manage trust assets. In this case, where the Trustees lacked the expertise to make investment decisions for the Trust, they delegated those functions to Warfield – and did not take any deduction for trustee fees.

Under the Commissioner's reading, where a trustee makes the investment decisions himself, the trust may deduct the fees that trustee has charged for managing the trust assets; but where those decisions are delegated, the fees charged for managing the trust assets may not be deducted. Congress surely cannot have intended such a result.

## IV. THIS CASE PRESENTS AN APPROPRIATE VEHICLE FOR RESOLUTION OF THIS SPLIT.

Finally, this case presents an appropriate vehicle for addressing the question that divides the Circuits. This Court routinely grants certiorari to resolve conflicts among the Circuits concerning federal tax law in cases in precisely this procedural posture, where a court of appeals has affirmed a Tax Court position to which it adhered after another court of appeals has reversed it on the same question. See, *e.g.*, *Commissioner v. Estate of Hubert*, 520 U.S. 93, 99 (1997); *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 206-207 (1990). In this case, the Second Circuit's erroneous reading of § 67(e) was dispositive. This case thus cleanly presents the legal issue in dispute and this case therefore presents an appropriate vehicle for resolution of the Question Presented. (Indeed, because the court below did not reach Petitioner's alternative argument below that the test of *Scott* and *Mellon Bank* was not met here, even if this Court were to disagree with Petitioner's proffered interpretation of the statute and agree with that put forward in those cases, reversal of the judgment below would be required.) There is certainly no need for further percolation of this issue. Indeed, the Second Circuit's decision to utilize its own test rather than adopting that of the Sixth or that of the Fourth and Federal Circuits indicates that additional court of appeals decisions on this question may produce only greater conflict and confusion.

Clarifying this issue now will also be particularly useful in assisting those subject to, and those who must enforce, this federal tax law. Although the aggregate amounts at stake are enormous and both the bench and bar require the guidance of this Court, because of the high cost of litigation, individual taxpayers denied this full deduction will ordinarily have insufficient incentive to pursue appeals. In this case, for example, the tax deficiency alleged for the one year at issue is only $4,448.00. Thus, while the issue clearly is a recurring one, deciding this issue now rather than later will

be of enormous benefit to innumerable taxpayers who would otherwise face this question without its resolution, as well as to the federal government.

Lastly, because New York is home to such a significant part of the financial services industry and, indeed, to such a significant portion of this nation's wealth, the decision by the Second Circuit that trusts and estates may not fully deduct investment advisory and management fees will have a more serious impact than would such a decision by any other court of appeals. This renders the need for review of the Question Presented in this case even more urgent.

## CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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MARCH 23, 2007

# APPENDIX

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# APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT.

August Term, 2005

(Argued: May 10, 2006 Decided: October 18, 2006)

Docket No. 05-5151-ag

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WILLIAM L. RUDKIN TESTAMENTARY TRUST, U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,

*Petitioner-Appellant,*

– v. –

COMMISSIONER of INTERNAL REVENUE,

*Respondent-Appellee.*

---

CAROL. A. CANTRELL, Briggs & Veselka Co., Bellaire, TX, for *Petitioner-Appellant.*

GILBERT S. ROTHENBERG, Attorney, Tax Division, United States Dept. of Justice (Eileen J. O'Connor, Assistant Attorney General; Anthony T. Sheehan, Attorney, Tax Division, United States Dept. of Justice, *on the brief*), Washington, D.C., for

*Respondent-Appellee.*

Gregory F. Taylor, Lisa Bleier, American Bankers Association, Washington, D.C., for *Amici Curiae American Bankers Association* and *New York Bankers Association.*

Before: SOTOMAYOR and HALL, *Circuit Judges.*[*]

SOTOMAYOR, *Circuit Judge*:

The question presented on this appeal is whether investment-advice fees incurred by a trust are fully deductible in calculating adjusted gross income for purposes of the Internal Revenue Code ("IRC") under 26 U.S.C. § 67(e)(1) (2000), or whether these fees are deductible only to the extent that they exceed two percent of the trust's adjusted gross income under § 67(a). Petitioner-appellant Michael J. Knight, trustee of the William L. Rudkin Testamentary Trust ("the Trust"), appeals from a decision of the United States Tax Court (Robert A. Wherry, Jr., J.). We affirm the decision of the tax court and hold that a trust's investment-advice fees are subject to the two-percent floor of § 67(a) and therefore not fully deductible in arriving at adjusted gross income.

## BACKGROUND

The parties in this case stipulated to the following facts. Henry A. Rudkin established the William L. Rudkin

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[*] Judge Wilfred Feinberg, originally a member of the panel, recused himself subsequent to oral argument. Because the remaining members of the Panel are in agreement, we decide this case in accordance with § 0.14(b) of the rules of this Court.

Testamentary Trust in Connecticut on April 14, 1967, for the benefit of his son William, William's wife and William's descendants and their spouses. The Trust was originally funded with proceeds from the sale of Pepperidge Farm, a food products company, to Campbell Soup Company. In 2000, Michael J. Knight, the trustee, engaged Warfield Associates, Inc. ("Warfield") to provide investment-management advice to the Trust. In its 2000 tax return, the Trust reported total income of $624,816 and claimed a deduction in the amount of $22,241 for investment-management fees paid to Warfield. The Trust claimed this deduction on line 15a of its tax return for "deductions not subject to the 2% floor"; the Trust claimed no deduction on line 15b for "[a]llowable miscellaneous itemized deductions subject to the 2% floor."

On December 5, 2003, the Internal Revenue Service (the "IRS") sent the Trust a notice of deficiency for the year 2000. In the notice, the IRS indicated that it rejected the Trust's itemized deduction for investment-advice fees in the amount of $22,241, and permitted such a deduction only in the amount of $9,780 (that portion of the fees which exceeded two percent of adjusted gross income of $623,050); as a result, the Trust owed $4,448 in taxes. The parties subsequently became aware that the notice contained an error in its calculation of the Trust's adjusted gross income and stipulated that the correct amount was $613,263. The parties therefore agreed that the corresponding deduction for investment-advice fees would be $9,976, but, for reasons not relevant here, agreed further that the resulting deficiency calculated in the December 5 notice would remain unchanged.

The Trust thereafter filed a petition disputing the assessed deficiency. It argued that the trustee's fiduciary duty – specifically, the investment duties defined under the Connecticut Uniform Prudent Investor Act, Conn. Gen. Stat. §§ 45a-541-45a-5411 (2005) – required investment advisory

services for the proper administration of the Trust's sizable stock portfolio and that the investment-advice fees were therefore fully deductible under § 67(e)(1). Following a trial in the United States Tax Court in Hartford, Connecticut, the tax court held that the "investment advisory fees paid by the trust are not fully deductible under the exception provided in section 67(e)(1) and are deductible only to the extent that they exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a)." *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304, 311 (2005). This timely appeal followed.

## DISCUSSION

This appeal, which we have jurisdiction to consider under 26 U.S.C. § 7482(a)(1) (2000), presents a question of statutory interpretation. In interpreting a statute, "[w]e start, as always, with the language of the statute." *Williams v. Taylor*, 529 U.S. 420, 431 (2000). "We give the words of a statute their ordinary, contemporary, common meaning, absent an indication Congress intended them to bear some different import." *Id.* (internal quotation marks omitted). "Our inquiry must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent." *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997) (internal quotation marks omitted). "The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole." *Id.* at 341, 117 S.Ct. 843. "[A]lthough a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there is no need to do so" if the statutory language is clear. *Toibb v. Radloff*, 501 U.S. 157, 162 (1991).

In considering the question of statutory interpretation presented on this appeal, we review the legal conclusions of the tax court *de novo*. *Reimels v. Comm'r*, 436 F.3d 344, 346

(2d Cir. 2006); 26 U.S.C. § 7482(a)(1) (providing that the courts of appeals "shall have exclusive jurisdiction to review the decisions of the Tax Court ... in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury"). "In particular, '[w]e owe no deference to the Tax Court's statutory interpretations, its relationship to us being that of a district court to a court of appeals, not that of an administrative agency to a court of appeals.' " *Callaway v. Comm'r*, 231 F.3d 106, 115 (2d Cir. 2000) (quoting *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (Posner, C.J.)).

I. *Statutory Framework*

Under the IRC, "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual," subject to one exception relevant to this appeal. 26 U.S.C. § 67(e). The exception provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" shall be fully deductible from gross income in calculating adjusted gross income. *Id.* § 67(e)(1). In order to understand this provision's operation, it is necessary first to comprehend the manner in which adjusted gross income is calculated for individuals.

Section 1 of the IRC imposes a tax on all "taxable income" of individuals and trusts. 26 U.S.C. § 1. In calculating taxable income, a taxpayer must first determine the amount of "gross income," which is defined as "all income from whatever source derived." *Id.* § 61(a). The taxpayer then arrives at "adjusted gross income" by subtracting from gross income certain "above-the-line" deductions, such as trade and business expenses and losses from the sale of property. *Id.* § 62(a). Finally, "taxable income" is calculated by subtracting from adjusted gross income any "itemized" (or "below-the-line") deductions. *Id.*

§ 63. In the case of an individual, "below-the-line" deductions include, *inter alia*, "all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income." *Id.* § 212.

Again in the case of an individual, "the miscellaneous itemized deductions [i.e., "below-the-line" deductions] for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." *Id.* § 67(a). Stated differently, the rule creates a "two-percent floor" for an individual's itemized deductions of the sort at issue here. Section 67(b) exempts from the two-percent floor certain specifically enumerated itemized deductions. *Id.* § 67(b). Investment-advice fees are generally treated as itemized deductions under § 212. 26 C.F.R. § 1.212-1(g) (specifying the circumstances in which "[f]ees for services of investment counsel . . . are deductible under section 212"). They are not listed in § 67(b), so are therefore not exempt from the two-percent floor established by § 67(a). Temp. Treas. Reg. § 1.67-1T(a)(1)(ii) (1988) (stating that "investment advisory fees" are subject to the two-percent floor of § 67(a)).

As noted, under § 67(e), trusts are generally subject to the same rules for calculating adjusted gross income that apply to individuals, with one exception that is relevant to this appeal. A trust's costs are fully deductible, rather than subject to the two-percent floor, if they satisfy both of the following two requirements: (1) they are "paid or incurred in connection with the administration of the . . . trust"; and (2) they "would not have been incurred if the property were not held in such trust." 26 U.S.C. § 67(e)(1). There is no dispute here that the investment-advice fees at issue meet the requirement of the first clause, that is, that the fees Knight paid to Warfield were incurred in connection with the administration of the Trust. Instead, the issue presented here, on which some of our sister circuits have disagreed, is whether the investment-

advice fees also satisfy the requirement of the second clause of § 67(e)(1) and therefore are fully deductible without regard to the two-percent floor of § 67(a).

II. *The Circuit Split*

The Sixth Circuit was the first federal court of appeals to consider the question presented here. It held that "the investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the base of two percent of adjusted gross income." *O'Neill v. Comm'r*, 994 F.2d 302, 304 (6th Cir. 1993). The Sixth Circuit reasoned that because a trustee has a fiduciary duty to manage trust assets as a "prudent investor," investment-advisory fees are "necessary to" the trust's administration and "caused by" the fiduciary duty of the trustee. *Id.* The court reasoned further that although individual investors often incur costs for investment advice, "they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* In short, O'Neill established the rule that a trust's costs attributable to the trustee's fiduciary duty, and not required outside the administration of trusts, fall within the § 67(e)(1) exception and are therefore fully deductible.[1]

The Federal Circuit rejected this reasoning in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001). In *Mellon Bank*, the court held that the second clause of § 67(e)(1) "serves as a filter" with respect to the first clause

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[1] The American Bankers Association and the New York Bankers Association, appearing in this case as *amici curiae*, advocate the position adopted by the Sixth Circuit. They contend that investment-advice fees incurred by a trustee are fully deductible under the statute "because the prudent execution of the duties imposed upon a trustee rendered it necessary to obtain investment advisory services."

and "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1280-81. Because "[i]nvestment advice and management fees are commonly incurred outside of trusts," the court reasoned, "these costs are not exempt under section 67(e)(1) and are required to meet the two percent floor of section 67(a)." *Id.* at 1281. The Federal Circuit also found its construction to be consistent with the statute's legislative history. *Id.* It concluded by noting that the trust's reading of the statute, which would find all costs arising out of the trustee's fiduciary duties to fall within the second clause of § 67(e)(1), rendered that clause superfluous "because any costs associated with a trust will always be deductible." *Id.*

The Fourth Circuit subsequently joined the Federal Circuit in holding that investment-advice fees incurred by a trust are subject to the two-percent floor of § 67(a). *Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003). Noting that the "text is clear and unambiguous," the Fourth Circuit stated that "trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers." *Id.* at 139-40. Applying this rule, the court concluded that because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the two-percent floor. *Id.* The court noted, however, that "[o]ther costs ordinarily incurred by trusts, such as fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e)." *Id.* These costs, the court explained, are "solely attributable to a trustee's fiduciary duties, and as such are fully deductible under § 67(e)." *Id.* Stating a rationale similar to the Federal Circuit's in Mellon Bank, the court said that to find a trust's investment-advice fees to be fully deductible would lead to

the conclusion that "[a]ll trust-related administrative expenses could be attributed to a trustee's fiduciary duties," rendering the second clause of § 67(e)(1) meaningless. *Id.*

III. *Analysis*

The Trust contends that the Sixth Circuit construed § 67(e)(1) correctly and that the Federal and Fourth Circuits interpreted the provision inconsistently with both its plain language and legislative history. The Trust's principal textual argument is that the second clause of § 67(e)(1) creates a "but for" causation test, excluding from full deduction only those costs which would have been incurred even in the absence of the trust's ownership of the property, i.e., without the trustee. The Trust also relies on the drafting history of § 67(e)(1) to make the somewhat different argument that by enacting that particular section, Congress intended only to prevent trusts from fully deducting those administrative expenses incurred by pass-through entities in which they had invested. For the reasons that follow, we reject both arguments.

A. *Statutory Language*

The Trust reads § 67(e)(1) to reflect Congress's intent to allow a full deduction for the administrative costs of a trust that are attributable to the fiduciary duty of the trustee. The Trust argues that the statute sets forth a "but for" causal test: if the cost would not have been incurred without the trustee, then it is attributable to the trustee's performance of its fiduciary duty and is thus fully deductible under § 67(e)(1). According to the Trust, therefore, the second prong of § 67(e)(1) requires no consideration of whether a generic individual owner of the same assets may have incurred the cost at issue. Rather, the Trust contends that the causation test "plainly" entails "a simple exercise of removing the trustee from the property and seeing which costs remain and which ones disappear without him." The Trust points to specific statutory language in advancing this view. It reads

the statute's use of the language "such trust" to refer to the specific trust under consideration, its trustee and that trustee's duties, rather than to the generic trust of § 67(e)'s introductory language, that is, a trust of the type to which § 67(e) is applicable.[2] Under the Trust's construction, the statute requires consideration of whether a particular cost would have been incurred if the trustee had never existed. It would ignore, however, how an individual property owner managing the same assets would have acted. For the following reasons, we find the Trust's interpretation unreasonable.

As an initial matter, had Congress intended to create a causation test of the type the Trust advances, which disregards what an individual asset owner may have done if the assets were not held in trust, it could have done so in language clearly expressing that intent. Such a "but for" causation test, however, is not apparent from the text's "ordinary, common meaning." *See Luyando v. Grinker*, 8 F.3d 948, 950 (2d Cir. 1993) (noting we interpret a statute according to the "ordinary, common meaning" of the statute's "plain language"). On the contrary, the phrase "if the property were not held in such trust" more logically directs

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[2] The Trust thus contends that the word "such" in the statute, emphasized below, refers to "the" estate or trust mentioned in the first clause of § 67(e)(1), also emphasized below, which it understands to refer not to the generic estate or trust mentioned in the introductory text of § 67(e)(1), but to the particular trust at issue.

> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as is the case of an individual, except that -(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate. . . .

26 U.S.C. § 67(e)(1) (emphasis added).

the inquiry away from the trust and back toward the hypothetical ownership of the property by an individual. That is, the introductory language of § 67(e) takes as its point of reference the rules that apply to individual taxpayers, and by using the phrase, "if the property were not held in such trust," Congress has aimed the inquiry at the costs that a hypothetical individual property owner could incur with respect to that property. We therefore agree with the Fourth Circuit's statement in *Scott* that the second prong of § 67(e)(1) does not ask whether the costs at issue are commonly incurred in the administration of trusts or are incurred as a result of a particular trustee's fiduciary duty. It focuses the inquiry, instead, on the hypothetical situation where the assets are in the hands of an individual. *See* 328 F.3d at 140.

Although the statutory language directs the inquiry toward the counterfactual condition of assets held individually instead of in trust, the statute does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue. Nothing in the statute indicates that Congress intended the test for the exception to the two-percent floor to give rise to factual disputes about whether an individual asset owner (or owners) is insufficiently financially savvy or the assets sufficiently large such that he or she unquestionably would have sought investment advice. Instead, the plain meaning of § 67(e)(1)'s second clause excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust. In other words, for the trust to avoid the two-percent floor and have advantage of the full deduction, the plain language of the statute requires certainty that a particular cost "would not have been incurred" if the property were not held in trust.

For that reason, the statute demands not a subjective and hypothetical inquiry, but rather an objective determination of whether the particular cost is one that is peculiar to trusts and

one that individuals are incapable of incurring. In other words, the statute sets an objective limit on the availability of a full deduction and, as the source of that limit, looks to those costs that individual property holders are capable of incurring and permitted to deduct from adjusted gross income. For example, the fact that investment-advice fees are subject to the two-percent floor under regulations applicable to individual taxpayers proves the fees to be a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust. By contrast, costs that individuals are incapable of incurring, like "fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns," *Scott*, 328 F.3d at 140, are fully deductible.

We thus join the Federal and Fourth Circuits in holding that § 67(e)(1) does not exempt from § 67(a)'s two-percent floor investment-advice fees incurred by trusts. We disagree, however, with their statement that costs "not *customarily* incurred outside of trusts" are the ones not subject to the floor, *Mellon Bank*, 265 F.3d at 1281 (emphasis added); *Scott*, 328 F.3d at 139-40 (citing *Mellon Bank* and stating that § 67(e)(1) subjects "expenses *commonly* incurred by individual taxpayers" to the two-percent floor (emphasis added)), because, as explained above, we believe § 67(e)(1) is more restrictive than that. While the Federal and Fourth Circuits' approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of § 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. We

therefore hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.

In so doing, we reject the Trust's argument that, in construing § 67(e)(1) to refer to costs incurred by a generic trust rather than the particular trust under consideration, we must ignore the word "such" in the second clause of § 67(e)(1). The statute's introductory language references a generic "estate or trust" by stating that, "[f]or the purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual," subject to the exception under consideration on this appeal. 26 U.S.C. § 67(e) (emphasis added). The first clause of § 67(e)(1) next uses the different phrase "*the* estate or trust" in setting forth the condition that, to qualify for a full deduction, a cost must be "paid or incurred in connection with the administration of the estate or trust." *Id.* § 67(e)(1) (emphasis added). The second clause of § 67(e)(1) refers to " such estate or trust" in establishing that an administrative cost is fully deductible only if it "would not have been incurred if the property were not held in such trust or estate." *Id.* (emphasis added). For the following reason, we agree with the Commissioner that, as used here, "such trust" is best understood as referring to the generic trust of § 67(e)'s introductory language and not to any actual, particular trust that incurred a cost subject to scrutiny. In the first clause of § 67(e)(1), the language "the estate or trust" plainly refers not to a particular trust under consideration, but to the generic estate or trust mentioned in the provision's introductory language. The phrase "such trust or estate" of § 67(e)(1)'s second clause also refers, therefore, to the generic estate or trust mentioned in both the introductory language of § 67(e) and in the first clause of § 67(e)(1). Moreover, as explained, nothing in the statute indicates that Congress intended to make applicability of the deduction dependent on what costs are peculiarly incurred by a specific trust.

Even if the statute's meaning were not plain and the Trust's alternative interpretation were not unreasonable, canons of statutory interpretation favor the Commissioner's interpretation of the statute. *See Natural Res. Def. Council, Inc. v. Muszynski*, 268 F.3d 91, 98 (2d Cir. 2001) ("If the plain meaning of a statute is susceptible to two or more reasonable meanings, i.e., if it is ambiguous, then a court may resort to the canons of statutory construction."). Specifically, our conclusion accords with the canon of statutory interpretation requiring that when the statute is ambiguous, we resolve interpretive disputes as to the availability of a tax deduction in favor of the government. "It is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' " *Holmes v. United States*, 85 F.3d 956, 961 n. 3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

B. *Legislative History*

The Trust also invokes the statute's legislative history to support a construction that is somewhat different from, and not obviously consistent with, its textual argument.[3] It

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[3] While the Trust's textual argument is essentially that fiduciary administrative costs are exempt from the two-percent floor, its argument based on the drafting history, as explained below, is that the second clause of § 67(e)(1) makes only the indirect administrative costs of a pass-through entity in which a trust has invested subject to the two-percent floor. If the second clause were so limited, one might think that the statute exempts from the two-percent floor more than simply fiduciary administrative costs. On this view, the statute would appear to exempt from the two-percent floor all costs incurred in connection with the administration of a trust except a trust's share of the administrative costs of a pass-through entity owned, at least in part, by the trust.

contends that the drafting history indicates that Congress added the second clause of § 67(e)(1) in order to restrict a trust's use of pass-through entities to avoid the two-percent floor of § 67(a) and not to limit the deductibility of any other administrative costs of a trust. Because we find the statute's text "clear and unambiguous," we need not address the Trust's legislative history arguments. *See Scott*, 328 F.3d at 139. Even if it were not, however, we disagree that this history supports the Trust's proposed interpretation of the statute discussed above or provides any reason to depart from our reading of the statute's meaning.[4]

Pass-through entities, such as partnerships, S corporations, common trust funds, and nonpublic mutual funds, generally do not pay income taxes at the entity level, but instead pass their tax liabilities on to ultimate taxpayers-generally individuals. *See* Temp. Treas. Reg. 1.67-2T (1988). In the Tax Reform Act of 1986, Congress sought to eliminate the ability of wealthy taxpayers to avoid the two-percent floor of § 67(a) by funneling income through pass-through entities. *See Issues Relating to Passthrough Entities: Hearings Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means on H.R. 1658, H.R. 2571, H.R. 3397, H.R. 4448*, 99th Cong. 1 (1986) (stating the Subcommittee's intent to scrutinize the role of pass-through entities in "facilitating and encouraging tax avoidance techniques"). If there were no restrictions on such entities,

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[4] We note that the legislative history upon which the Federal Circuit relied in *Mellon Bank*, 265 F.3d at 1281, chiefly H.R. Rep. No. 99-426 (1985) and S. Rep. No. 99-313 (1986), predates the introduction of § 67(e)(1)'s second clause, and this history relates to a bill that treated all costs incurred in the administration of a trust or an estate as fully deductible. Thus, unlike the Federal Circuit, we do not view this history as persuasive evidence of the meaning of § 67(e)(1).

an individual could deduct the full cost of investment advice, for example, by placing his or her investments in a pass-through entity, deducting the cost of the advice at the entity level and reporting only the net investment income on his or her individual tax return. Congress addressed this problem by enacting § 67(c), which provides, inter alia, that regulations shall be issued "which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual." 26 U.S.C. § 67(c)(1). Congress also provided, however, that this rule, except as provided in regulations, shall not apply to trusts. *Id.* § 67(c)(3)(B).

At the time Congress added § 67(c), the bill provided that all costs incurred in connection with the administration of a trust were exempted from the two-percent floor of § 67(a) and thus permitted trusts to deduct fully all of their administrative costs. Section 67(e)(1)'s second clause was not included in the versions of the bill that emerged initially from the House and Senate, but was added only in the joint conference draft.[5] Accordingly, under the draft language of §

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[5] The House bill included the following language:

> (c) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.-For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income.

H.R. 3838, 99th Cong. § 67(c) (1985). The Senate Committee on Finance did not amend this provision, but expressed the view that "the bill attempts to reduce the benefits arising from the use of trusts ... by revising the rate schedule applicable to trusts." S. Rep. No. 99-313, 99th Cong. 868 (1986). The second clause of § 67(e)(1) appeared for the first time in the final version of the bill that emerged in the Joint Conference (...continued)

67(e) at the time Congress added § 67(c), a trust, unlike an individual, could fully deduct the cost of investment advice and other administrative expenses incurred by pass-through entities in which the trust had invested. To correct this problem, the Trust argues, Congress added the second clause of § 67(e)(1): trusts and estates could fully deduct only those administrative costs that "would not have been incurred if the property were not held in such trust or estate." According to the Trust, this language was intended to create a limited exception within an exception. Although trust income is to be calculated in the same way as individual income, administrative costs incurred by a trust are not subject to the two-percent floor of § 67(a), except for those administrative costs incurred by a pass-through entity in which the trust has invested (which are subject to the floor).[6]

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Agreement. *See* H.R. Rep. No. 99-841, vol. II, at 34 (1986) (Conf. Rep.), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.

[6] The Trust relies most heavily in making this argument on the House Conference Report, which provides some indication that the second clause of § 67(e)(1) was drafted to address indirect deductions through pass-through entities. The Trust relies on the following passage from the Report:

> Pursuant to Treasury regulations, the [two-percent] floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs. The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of present-law grantor trust and pass-through rules. *In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are*

(...continued)

If Congress's only purpose had been to restrict the ability of trusts as ultimate taxpayers to deduct fully their share of the administrative costs of pass-through entities in which they had invested, however, it could have drafted the second clause of § 67(e)(1) more narrowly. It could have, for example, permitted full deductibility for those administrative costs "which are not pass-through costs restricted under section 67(c)." Instead, Congress chose the broader language of § 67(e)(1). Thus, notwithstanding the narrow purpose the Trust attributes to Congress in enacting the second clause of § 67(e)(1), the broad statutory language is the best indication that Congress intended to treat those administrative costs that would be subject to the two-percent floor when incurred by an individual as similarly subject to that floor when incurred by a trust. Nothing in the legislative history suggests a clearly expressed congressional intent contrary to the plain meaning of the statute itself.[7] *See Toibb*, 501 U.S. at 162, 111 S.Ct. 2197.

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> *not subject to the floor.* The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.

H.R. Rep. No. 99-841, at 34, reprinted at 1986 U.S.C.C.A.N. 4075, 4122 (emphasis added).

[7] The Trust also argues that its reading of the statute in light of the legislative history eliminates the superfluity problem that the Federal and Fourth Circuits, as well as the Commissioner in this case, identified. The Federal and Fourth Circuits both concluded that to interpret § 67(e)(1)'s second clause similarly to the "but for" causation test the Trust advances here renders that clause superfluous because "[a]ll trust-related administrative expenses could be attributed to a trustee's fiduciary duties." *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281 ("Under Mellon's construction, the second prerequisite of section 67(e)(1) would (...continued)

## CONCLUSION

Because § 67(e)(1) unambiguously exempts from the two-percent floor of § 67(a) only those costs incurred by a trust that could not have been incurred if the property were held by an individual, we conclude that the Trust's investment-advice fees are deductible only to the extent that they exceed two percent of the Trust's adjusted gross income. This conclusion follows from the fact that individual property owners obviously can incur investment-advice fees and from the regulation explicitly including investment-advice fees among an individual's miscellaneous itemized deductions subject to § 67(a)'s two-percent floor. *See* Temp. Treas. Reg. § 1.67-1T(a)(1)(ii). Accordingly, the investment-advice fees the Trust paid to Warfield do not meet the requirements of § 67(e)(1) and therefore are not fully deductible. For the foregoing reasons, we AFFIRM the judgment of the tax court.

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be rendered superfluous because any costs associated with a trust will always be deductible."). We do not adopt the Federal and Fourth Circuits' view. The Trust contends that the second clause is necessary to filter out a specific subset of the administrative costs described in the first clause-those incurred by pass-through entities in which a trust has invested. Assuming arguendo that such costs are "incurred in connection with the administration" of a trust for purposes of the statute (and satisfy the first clause), they are not caused by the trustee's fiduciary duty (and so fall outside the Trust's reading of the second clause). We find it difficult to conceive that a trustee's fiduciary duty could require that trust assets be invested in a particular vehicle.

# APPENDIX B

124 T.C. No. 19

UNITED STATES TAX COURT

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3297-04. Filed June 27, 2005.

T is a trust established in 1967. The trustee engaged an outside firm to provide investment management advice for T, and the firm was paid $22,241.31 for such services during the 2000 taxable year. On its Federal income tax return, T deducted these fees (rounded) in full.

*Held*: The investment advisory fees paid by T are not fully deductible under the exception provided in sec. 67(e)(1), I.R.C., and are deductible only to the extent that they exceed 2 percent of the T's adjusted gross income pursuant to sec. 67(a), I.R.C.

Michael J. Knight (specially recognized), for petitioner.

*Frank W. Louis*, for respondent.

WHERRY, *Judge*: Respondent determined a Federal income tax deficiency in the amount of $4,448 with respect to the 2000 taxable year of the William L. Rudkin Testamentary Trust (the trust). The sole issue for decision is whether investment advisory fees paid by the trust are fully deductible under the exception provided in section 67(e)(1) or whether the fees are deductible only to the extent that they

exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a).[1]

## FINDINGS OF FACT

The majority of the facts have been stipulated and are so found. The stipulations of the parties, with accompanying exhibits, are incorporated herein by this reference. Michael J. Knight serves as trustee of the trust and provided an address in Fairfield, Connecticut, at the time the petition in this case was filed.

The trust was established under the will of Henry A. Rudkin on April 14, 1967.[2] Henry A. Rudkin's family was involved in the founding of Pepperidge Farm, a food products company. Pepperidge Farm was sold to Campbell Soup Company in the 1960s, and the trust was initially funded primarily with proceeds from that sale.

The will of Henry A. Rudkin referenced above sets forth the governing provisions of the trust. In general, income and principal of the trust were to be applied for the benefit of Henry A. Rudkin's son, William L. Rudkin, and the son's spouse, descendants, and spouses of descendants. Principal distributions were also subject to a special power of appointment held by William L. Rudkin. The trustee and other fiduciaries of Henry A. Rudkin's estate were provided with broad authority in the management of property,

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the year in issue, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2] The will refers to the trust as the "William L. Rudkin Family Testamentary Trust", but all other documents contained in the record omit "Family" from the name. The difference is not material.

including the authority "to invest and reinvest the funds of my estate or of any trust created hereunder in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel".

The trustee engaged Warfield Associates, Inc., to provide investment management advice for the trust. During the taxable year 2000, Warfield Associates, Inc., was paid $22,241.31 for its services.

A Form 1041, U.S. Income Tax Return for Estates and Trusts, for the 2000 year was timely filed on behalf of the trust. Thereon the trust reported total income of $624,816. The Form 1041 also reflected, among other things, a deduction of $22,241 on line 15a for "Other deductions *not* subject to the 2% floor", further described on an attached statement as "INVESTMENT MANAGEMENT FEES". No deduction was claimed on line 15b for "Allowable miscellaneous itemized deductions subject to the 2% floor".

On December 5, 2003, respondent issued to the trust a statutory notice of deficiency determining the aforementioned $4,448 deficiency for the taxable year 2000. Respondent disallowed full deduction of the $22,241 in investment fees and instead permitted a deduction of $9,780, the amount by which $22,241 exceeded 2 percent of adjusted gross income of $623,050 (i.e., $12,461).

The trustee filed the underlying petition in this case disputing respondent's determination on grounds that the

investment advisory fees should not be subject to the 2-percent limitation. During trial preparations, the parties became aware that the notice of deficiency contained an error in its computation of adjusted gross income. The parties have now stipulated that the correct adjusted gross income figure is $613,263, for a corresponding deduction under respondent's position of $9,976. However, on account of the alternative minimum tax, the parties are in further agreement that the resultant deficiency if respondent's position is sustained remains unchanged at $4,448.

## OPINION

### I. *General Rules*

As a general rule, the Internal Revenue Code imposes a Federal tax on the taxable income of every individual and trust. Sec. 1. Taxable income is defined as gross income less allowable deductions. Sec. 63(a). Gross income broadly comprises "all income from whatever source derived," sec. 61(a), and allowable deductions are calculated through application of a multi-tiered process. First, certain enumerated deductions may be subtracted from gross income to arrive at adjusted gross income. Sec. 62(a). Itemized deductions may then be subtracted from adjusted gross income in arriving at taxable income. Sec. 63(d).

Itemized deductions, however, are further segregated into two categories that impact on their deductibility. Section 67(b) sets forth a list of itemized deductions allowed without further limitation to the extent permitted under the appropriate statutory section authorizing the deduction. For individual taxpayers, the remaining itemized deductions are characterized as "miscellaneous itemized deductions" and are allowed under section 67(a) only to the extent that they exceed 2 percent of adjusted gross income. For estates and

trusts, section 67(e) mandates application of the rule of section 67(a), with specified modifications. Specifically, section 67 provides as follows in relevant part:

> SEC. 67. 2-PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS.
>
> (a) General Rule.-In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.
>
> * * * * * * * * *
>
> (e) Determination of Adjusted Gross Income in Case of Estates and Trusts.-For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that-
>
> (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate * * *
>
> * * * * * * * *
>
> shall be treated as allowable in arriving at adjusted gross income. * * *

Hence, the statutory text of section 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection

with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

In that vein, regulations promulgated under section 67 list examples of expenses that, in the context of individuals, are subject to the 2-percent floor. Sec. 1.67-1T(a)(1), Temporary Income Tax Regs., 53 Fed. Reg. 9875 (Mar. 28, 1988).[3] Included are expenses incurred "for the production or collection of income for which a deduction is otherwise allowable under section 212(1) and (2), such as *investment advisory fees*, subscriptions to investment advisory publications, certain attorneys' fees, and the cost of safe deposit boxes". Sec. 1.67-1T(a)(1)(ii), Temporary Income Tax Regs., *supra* (emphasis added).

II. *Contentions of the Parties*

Against this backdrop, the trustee contends that the investment management fees in dispute here are properly deductible under the exception set forth in section 67(e)(1). The trustee maintains that the fees were paid in connection with administration of the trust and would not have been incurred if the property were not held in trust. In reaching this conclusion, the trustee relies largely on the fiduciary duties imposed on trustees. According to the trustee, while an individual may make a voluntary and personal choice to seek investment advice, fiduciary duties render such professional advice a necessary and "involuntary" component of trust administration.

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[3] Temporary regulations are entitled to the same weight and binding effect as final regulations. *Peterson Marital Trust v. Commissioner*, 102 T.C. 790, 797 (1994), affd. 78 F.3d 795 (2d Cir. 1996).

In contrast, it is respondent's position that the section 67(e)(1) exception does not apply to the expenses at issue. Respondent does not dispute the expenditures were made in connection with the administration of the trust. However, respondent alleges that because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the fees fail to satisfy the requirement that they would not have been incurred if the assets were not held in trust. It is also respondent's view that neither State law nor the governing trust instrument imposed a legal obligation on the fiduciary to obtain professional investment management services.

III. *Analysis*

The deductibility of investment advisory fees by a trust under section 67(e)(1) is not a matter of first impression. This Court and three Courts of Appeals have ruled on the question. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001); *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), revg. 98 T.C. 227 (1992). The result has been a split in authority on the issue.

This Court in *O'Neill v. Commissioner*, 98 T.C. at 230-231, held that investment advice costs were not deductible under section 67(e), reasoning as follows:

> We believe that the thrust of the language of section 67(e) is that only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth at section 67(a). Examples of items unique to the administration of a trust or estate would be the

> fees paid to a trustee and trust accounting fees mandated by law or the trust agreement. Individual investors routinely incur costs for investment advice as an integral part of their investment activities. Consequently, it cannot be argued that such costs are somehow unique to the administration of an estate or trust simply because a fiduciary might feel compelled to incur such expenses in order to meet the prudent person standards imposed by State law.

The Court of Appeals for the Sixth Circuit reversed in *O'Neill v. Commissioner*, 994 F.2d at 304-305. Although the Court of Appeals concurred that "certain expenditures unique to trust administration are excepted from the two percent floor", the Court disagreed with our analysis as to why the costs in dispute were not unique. *Id.* at 303-304. Noting our statement that individual investors routinely incur costs for investment advice, the Court of Appeals opined: "Nevertheless, they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." *Id.* at 304.

Subsequently, the Courts of Appeals for the Federal and Fourth Circuits in *Mellon Bank, N.A. v. United States*, supra, and *Scott v. United States*, *supra*, respectively, diverged from the position taken by the Court of Appeals for the Sixth Circuit. These latter rulings were consistent in their rationale and result, summarized as follows by the Court of Appeals for the Fourth Circuit:

> the second requirement of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether

> costs are commonly incurred *outside* the administration of trusts. As the Federal Circuit decided in *Mellon Bank*, investment-advice fees are commonly incurred outside the administration of trusts, and they are therefore subject to the 2% floor established by § 67(a). * * * [*Scott v. United States*, *supra* at 140.]

See also *Mellon Bank, N.A. v. United States*, *supra* at 1281 ("the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts").

In construing section 67(e)(1), the Courts of Appeals for both the Federal and Fourth Circuits emphasized the importance of not interpreting the statute so as to render superfluous any portion thereof. *Scott v. United States*, *supra* at 140; *Mellon Bank, N.A. v. United States*, *supra* at 1280. Moreover, both courts explicitly rejected the taxpayers' arguments premised on fiduciary duties as running afoul of this principle of construction. *Scott v. United States*, *supra* at 140; *Mellon Bank, N.A. v. United States*, *supra* at 1280-1281. In the words of the Court of Appeals for the Fourth Circuit:

> we would, by holding that a trust's investment-advice fees were fully deductible, render meaningless the second requirement of § 67(e)(1). All trust-related administrative expenses could be attributed to a trustee's fiduciary duties, and the broad reading of § 67(e)(1) urged by the taxpayers would treat as fully deductible any costs associated with a trust. But the second clause of § 67(e)(1) specifically limits the applicability of § 67(e) to certain types of trust-related administrative expenses. To give effect to this limitation, we must

> hold that the investment-advice fees incurred by the Trust do not qualify for the exception created by § 67(e). Rather, they are subject to the 2% floor established by § 67(a). [*Scott v. United States*, *supra* at 140.]

The Court of Appeals for the Fourth Circuit characterized the contrary analysis in this regard of the Court of Appeals for the Sixth Circuit in *O'Neill v. Commissioner*, 994 F.2d at 304, as containing "a fatal flaw". *Scott v. United States*, *supra* at 140. The Court of Appeals for the Federal Circuit similarly branded the taxpayer's attempts to bolster its interpretation through legislative history as "unpersuasive." *Mellon Bank, N.A. v. United States*, *supra* at 1281. To wit, the Court of Appeals for the Federal Circuit, tracing the genesis of section 67(e), noted that to premise full deduction of all trust expenses on fiduciary duties would run counter to

> legislative intent to equate the taxation of trusts with the taxation of individuals, limit the ability of sophisticated taxpayers to use trusts or other complex arrangements to lower their tax burden compared to similarly situated individuals, and to minimize the impact of the tax code on economic decision making. [*Id.*]

Having reviewed our initial construction of section 67(e) and the ensuing judicial developments detailed above, this Court concludes that the interpretation set forth in *O'Neill v. Commissioner*, 98 T.C. at 230-231, and expressed by the Courts of Appeals in *Scott v. United States*, 328 F.3d at 139-140, and *Mellon Bank, N.A. v. United States*, 265 F.3d at 1280-1281, remains sound. The trustee here, in support of full deductibility, relies on concepts rejected in the foregoing decisions. Appeal in the instant case, barring stipulation to the contrary, would be to the Court of Appeals for the Second

Circuit, which has not ruled on the issue. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir.1971). The Court therefore holds that the investment advisory fees paid by the trust are not fully deductible under the exception provided in section 67(e)(1) and are deductible only to the extent that they exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a).

To reflect the foregoing,

*Decision will be entered for respondent.*

Reviewed by the Court.

GERBER, COHEN, SWIFT, WELLS, COLVIN, HALPERN, CHIECHI, LARO, FOLEY, VASQUEZ, GALE, THORNTON, MARVEL, HAINES, GOEKE, KROUPA, and HOLMES, JJ., agree with this opinion.

## APPENDIX C

# UNITED STATES COURT OF APPEALS
## FOR THE SECOND CIRCUIT
## THURGOOD MARSHALL U.S. COURTHOUSE
## 40 FOLEY SQUARE
## NEW YORK 10007

Thomas Asreen
ACTING CLERK

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
FILED
Date: JAN 19 2007

| | |
|---|---|
| Docket | 05-5151-ag |
| Short Title: | William L. Rudkin Testamentary Trust v. Commission |
| Agency Number: | 3279-04 |
| Agency: | Tax Court, Internal Revenue Service |

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 19 day of January two thousand seven.

William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant William L. Rudkin Testamentary Trust. Upon consideration by the

panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED**.

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court,
Thomas Asreen, Acting Clerk

By: /s/_____
Motion Staff Attorney

## APPENDIX D

I, HENRY A. RUDKIN, of the Town of Fairfield, County of Fairfield, State of Connecticut, hereby make, publish and declare this my LAST WILL AND TESTAMENT, hereby revoking any and all Wills and Codicils heretofore made by me.

ARTICLE FIRST. If my wife, MARGARET RUDKIN, survives me by six months, I give to her my interest in any real estate which she and I own as tenants in common in the States of Connecticut and Florida.

ARTICLE SECOND.

(1) If my wife, MARGARET RUDKIN, survives me by six months, I give to her all of my tangible personal property. If she does not survive me by six months, I give all of such property in equal shares per stirpes to descendants living at my death. I request (but I do not direct) the donee or donees of such property to dispose of certain articles thereof in accordance with a memorandum or list which I expect to attach to this will, or if I should fail to attach such a memorandum or list, in accordance with his or their knowledge of my wishes as I have expressed them or may hereafter express them from time to time.

(2) If my wife, MARGARET RUDKIN, survives me by six months, I give to her that fraction of my residuary estate (before the payment of the estate, inheritance, succession and similar taxes thereon), which equals the maximum marital deduction allowable in the final determination of the Federal Estate Tax upon my estate, reduced by the value as finally determined for Federal Estate Tax purposes of all other items of my gross estate

Identifying Initials /s/ HAR

qualifying for said marital deduction which pass or have passed to my wife under other provisions of this Will or by operation of law or otherwise. The final determination in the Federal Estate Tax proceedings shall control the computation of such fractional share. When distribution of my residuary estate is made, the fractional share thereof as computed above shall be distributed to my wife regardless of whether the then value of my residuary estate is more or less than the value thereof used in the final determination of the Federal Estate Tax.

ARTICLE THIRD. At any time within ninety days following the filing with the probate court having jurisdiction of my estate of an inventory and appraisal thereof, I authorize my wife, MARGARET RUDKIN, to disclaim, either in whole or in part, any gifts, interests of benefits which would otherwise pass to her under ARTICLES FIRST or SECOND hereof, by written instrument or instruments filed with the Executors hereinafter named.

* * *

ARTICLE FIFTH. I give forty-five per cent of all the rest of my property and estate, of whatsoever the same may consist and wheresoever the same may be located, (or the remaining fifty per cent thereof if my son, JOHN MARK RUDKIN, does not survive me), to the trustees hereinafter named (hereinafter called the "Trustees") IN TRUST (as the "William L. Rudkin Testamentary Family Trust") for the following purposes and upon the following terms:

Identifying Initials /s/ HAR

(1) Until twenty-one years after the death of the last survivor among my descendants living at my death (or until the earlier deaths of my son, WILLIAM L. RUDKIN, and all of his descendants), the Trustees shall pay to or apply the for the benefit of all or any of the members from time to time of the class comprising my son, WILLIAM L. RUDKIN, his wife or widow, and the descendants and spouses of descendants of my said son, so much of the net income of the trust as the Trustees deem necessary or desirable in their discretion for the support, comfort and education of such members, or any one or more of them, with no requirement of equality of treatment among them, it being my intention and desire that the Trustees shall make such payment in accordance with their understanding of the individual and varying needs and resources from time to time of the members of such class; and the Trustees shall annually pay any income not so distributed in accordance with the foregoing provisions to the Trustee hereunder, to be held IN TRUST for such members, or any one or more of them, in trusts separate and apart from the trust created hereby, without any requirement of equality of treatment among such trusts; and each such trust so maintained for any such member shall be held and administered in accordance with the terms and for the purposes set forth in ARTICLE SEVENTH hereof, dealing with beneficiaries' accumulation trusts.

(2) During the existence of the trust, the Trustees may in their discretion at any time or from time to time distribute all or any part of the principal of the trust to any one or more of the members of the class described in subsection (1) of this ARTICLE FIFTH, with no requirement of equality in making such distribution.

Identifying Initials /s/ HAR

(3) During the existence of the trust, the Trustees shall distribute such portions of the principal of the trust to such persons and organizations (excluding my son, WILLIAM L. RUDKIN, his estate, his creditors and the creditors of his estate), and in such shares, in trust or otherwise, as my son, WILLIAM L. RUKIN, shall direct by written instrument or instruments delivered to the Trustees during his life or by specific reference to this special power of appointment in his Will duly admitted to probate.

(4) Twenty-one years after the death of the last survivor among my descendants living at my death (or on the earlier deaths of my son, WILLIAM L. RUDKIN, and all of his descendants), the Trustees shall transfer and deliver the principal of the trust as then constituted in equal shares per stirpes to the descendants then living of my son, WILLIAM L. RUDKIN (or in equal shares per capita if all such descendants are members of the same generation); or, if there be no such descendant, in equal shares per stirpes to my descendants then living (or in equal shares per capita if all such descendants are members of the same generation).

* * *

ARTICLE TENTH. I authorize my Executors and Trustees, in their respective capacities and discretions, as follows:

(1) to settle on such terms as they may deem advisable any claims of my estate or of any trust created hereunder against others or of others against my estate or against such trust;

(2) to complete any contracts and to pay or extend or renew any loans or debts which I may have or which may be owing to me at my death;

(3) to borrow from time to time such sums as they may deem advisable to facilitate the exercise of any rights, options, or privileges of the character referred to in subdivision (10) of this ARTICLE TENTH or for such other purposes as them may deem advisable for the preservation or benefit of my estate or of any trust created hereunder, and to secure any sum so borrowed by the pledge or mortgage of any securities or other properties constituting a part of my estate or of such trust;

(4) to sell, lease, mortgage, pledge, transfer, exchange or otherwise dispose of any securities or other properties which I may own at my death or which may come into their possession or under their control at any time hereunder upon such terms as to the payment or otherwise (including with respect to any lease, the term thereof) as they may deem advisable, and to execute and deliver such deeds, leases, assignments or other written instruments, with or without covenants, as may be necessary

Identifying Initials /s/ HAR

or convenient to accomplish such purposes (and no purchaser, lessee, mortgagee, pledgee, transferee or exchangee shall be required to see to the application of the proceeds thereof or to inquire into the validity, expediency or propriety thereof);

(5) to determine the date for the valuation of property in my gross estate for purposes of the Federal Estate Tax;

(6) to claim any expenses of administration of my estate as income tax deductions upon an income tax return or returns whenever in the judgment of my executors such action will achieve an over-all reduction in income and death taxes, and without making any adjustment therefor of income and principal accounts in my estate;

(7) to invest and reinvest the funds of my estate or of any trust created hereunder in such manner as they deem advisable without being restricted to the investments of the character authorized by law for the investment of estate or trust funds; including the investment in non-income producing securities and securities issued by the United States, any State, any municipality and any political subdivision of the United States, any State or any municipality and the holding of funds uninvested such as they may deem advisable;

(8) to purchase investment securities at a premium or discount and without any obligation to amortize such premium or discount;

(9) to cause any investment securities or other properties held by them hereunder to be registered or held in the name or names of a nominee or nominees without being required to

describe the capacity in which or the authority under which such securities or other properties are held, or to hold any such securities or other properties unregistered and in bearer form, without in any such case thereby changing their liability hereunder;

(10) to vote in person or by proxy any securities or other properties held by them hereunder with respect to which voting rights may at any time be exercised by the holders thereof; to exercise any rights, options or exchange or conversion privileges at any time pertaining to any securities or other properties held by them hereunder; and, generally, to exercise in respect of any securities or other properties held by them hereunder all such rights, powers and privileges as could be exercised lawfully by any natural person owning similar securities or other properties in his own right;

(11) to continue in force any policies of insurance on the life of my wife, MARGARET RUDKIN, which I may own at my death and, without limiting the generality of the foregoing or of the investment authority conferred by subsection (7) of this ARTICLE TENTH, to purchase insurance on the life of the beneficiary of any trust created hereunder or on the life of any person in whom such beneficiary has an insurable interest, naming as the beneficiary of any such policy either the trust itself or the beneficiary on whom or with respect to whom the policy was taken out; to pay premiums, assessments, and proper charges on any such policy either out of income or principal; and to exercise all or any rights granted under any such policy as they in their discretion deem necessary or desirable;

Identifying Initials /s/ HAR

(12) to make all payments, division and distributions hereunder either in money or in property or partly in money and partly in property as they may deem advisable, their judgment as to the fairness and equality of such payment, division or distribution to be final and binding upon all persons interested hereunder as to both the kind and value of any property designated by them for such disposition;

(13) to pay or deliver all or any part of the money or other property to which any minor or incompetent person shall be entitled to hereunder to the parent or to the legal guardian of the person of such minor or to any person with whom such minor is residing or to the legal representative of such incompetent person and to accept the receipt of such parent or guardian or person or legal representative for the money other property so paid over or delivered as a full release from further responsibility therefor;

(14) to pay to the beneficiary entitled to the next succeeding estate any dividends declared but not paid and any interest or other income accrued but not received on or before the date of the termination of the preceding estate;

(15) to determine what expenses, costs, taxes and other charges of all kinds (including executors' and Trustees' fees) shall be charged against income and what against principal or to apportion the same between income and principal in such amounts as they may deem proper, their decision with respect thereto to be final and binding upon all persons interested hereunder;

(16) to apportion appreciation or capital gain realized on the sale of any non-income producing security or other non-

income producing property held by them hereunder between income and principal in such amounts as they may deem proper, their decision with respect thereto to be final and binding upon all persons interested hereunder;

(17) to rely upon any affidavit, certificate, letter, notice, telegram or other paper or upon any telephone conversation believed by them to be genuine and upon any other evidence believed by them to be sufficient, and to be protected and saved harmless in all payments or distributions required to be made hereunder if made in good faith and without actual notice or knowledge of the changed condition or status of any person receiving payments or other distributions upon a condition;

(18) to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel; and

(19) to deal generally with my estate and with any trust created hereunder as in their judgment the best business interests thereof may require.

* * *

IN WITNESS WHEREOF, I have hereunto set my hand and seal to this Will (consisting of this page and the twenty-five preceding typewritten pages, each of which is identified by my initials at the bottom thereof) at Fairfield, Connecticut, this day of October, One Thousand Nine Hundred and Sixty-Five.

/s/ Henry A. Rudkin (L.S.) [seal]

Signed, sealed and declared to be his LAST WILL AND TESTAMENT by the above-named Testator, HENRY A. RUDKIN, in the presence of us, who, in his presence and at his request and in the presence of each other, have hereunto subscribed our names as witnesses

| | |
|---|---|
| /s/ Robert J. Berta | Shelton, Connecticut |
| /s/ Marie N. Pennell | Fairfield, Conn. |
| /s/ David O. Pendleton | Westport, Conn. |

STATE OF CONNECTICUT)
:ss.Fairfield, October 11, 1965
COUNTY OF FAIRFIELD )

The within-named ROBERT J. BERTA, MARIE N. PENNELL, and DAVID O. PENDLETON, being duly sworn, depose and say that they witnessed the within WILL of the within-named Testator, HENRY A. RUDKIN, and subscribed the same in his presence and at his request, and in the presence of each other; that the said HENRY A. RUDKIN, at the time of the execution of said WILL, appeared to them to be of full age and of sound mind and memory; and that he signed said WILL and declared the same to be his LAST WILL AND TESTAMENT in their presence, and that they make this affidavit at the request of said Testator.

/s/ Robert J. Berta
/s/ Marie N. Pennell
/s/ David O. Pendleton

Subscribed and sworn to at the request of the within-named Testator, HENRY A. RUDKIN, the day and year above written, before me,

/s/ _____

Notary Public

# CODICIL

to

LAST WILL AND TESTAMENT

of

HENRY A. RUDKIN

DATED:

MARSH, DAY & CALHOUN
BRIDGEPORT

I, HENRY A. RUDKIN of the Town of Fairfield, County of Fairfield and State of Connecticut, hereby make, publish and declare the following to be the First Codicil to my LAST WILL AND TESTMAMENT dated October 11, 1965 hereby confirming said LAST WILL AND TESTAMENT in all particulars except as herein expressly modified:

* * *

THIRD: I hereby amend and change subsection (2) of ARTICLE FIFTH of my said LAST WILL AND TESTAMENT to read as follows:

> "(2) During the existence of the trust, the Trustees may in their discretion at any time or from time to time distribute to any one or more members of the class described in subsection (1) of this ARTICLE FIFTH so much of the principal of such trust as the Trustees may deem necessary or desirable in their discretion for the education, support, comfort and welfare of such members, or any one or more of them, and may also in their discretion make such payments of principal to any one or more of such member of such class as they shall deem necessary or desirable

/s/ HAR

to advance the best interests of such member or members in any business venture in which such member or members may be engaged or in which such member or members may wish to engage. In making all such distributions, there shall be no requirement of equality as among various members of the class, and the Trustees shall not be bound to take into account the other sources of income or the capital resources of such members."

* * *

IN WITNESS WHEREOF, I have hereunto set my hand and seal at Fairfield, Connecticut, this 1st day of December One Thousand Nine Hundred and Sixty-five.

/s/ Henry A. Rudkin (L.S.) [seal]

Signed, sealed and declared to be a CODICIL to his LAST WILL AND TESTAMENT by the above-named Testator, HENRY A. RUDKIN, in the presence of us, who in his presence and at his request, and in the presence of each other, have hereunto subscribed our names as witnesses.

| | |
|---|---|
| /s/ Robert J. Berta | Shelton, Conn. |
| /s/ Marion Ryan | Norwalk, Conn. |
| /s/ Marie N. Pennell | Fairfield, Conn. |

STATE OF CONNECTICUT)
:ss.Fairfield, December 1, 1965
COUNTY OF FAIRFIELD )

The within-named Robert J. Berta, Marion Ryan and Marie N. Pennell, being duly sworn, depose and say that they

witnessed the within CODICIL to the LAST WILL AND TESTAMENT of the within-named Testator, HENRY A. RUDKIN, and subscribed the same in his presence and at his request, and in the presence of each other; that the said HENRY A. RUDKIN, at the time of the execution of said CODICIL, appeared to them to be of full age and of sound mind and memory, and that he signed said CODICIL and declared the same to be a CODICIL to his LAST WILL AND TESTAMENT in their presence, and that they make this affidavit at the request of said Testator.

/s/ Robert J. Berta

/s/ Marion Ryan

/s/ Marie N. Pennell

Subscribed and sworn to at the request of the within-named Testator, HENRY A. RUDKIN, the day and year above written, before me,

/s/_____

Notary Public

## APPENDIX E

**JPMorgan**
**Private Bank**

**A. Dean Theiss, Jr., CTFA**
Vice President & Manager
Fiduciary Specialized Services

February 21, 2007

Dear Tax Preparer:

Please find enclosed the tax worksheet(s) and other relevant information for the trust(s) for which you have been engaged to prepare the income tax return(s). We would like to make you aware of recent court cases that may have an impact on the tax treatment of the deductibility of investment fees or asset custody fees paid.

A number of years ago the Federal income tax law was changed for both individual and trust taxpayers. The law currently states that for the purpose of computing the regular income tax, certain miscellaneous expenses must be reduced by 2% of the adjusted gross income before deducting them on a tax return. It also states that, for the purpose of computing the alternative minimum tax, miscellaneous itemized deductions are completely disallowed. The 2% rule does not apply to trust administrative expenses that would not have been incurred had the property not been placed in trust. For example, trustee commissions are generally not considered to be miscellaneous itemized deductions since they are administrative expenses unique to trust accounts. Alternatively, investment management fees and asset custody fees are considered miscellaneous itemized deductions that would be subject to the 2% rule.

The application and interpretation of the tax law to trust accounts has not been consistent in the court systems. Previously we had been relying on a favorable decision in the Sixth Circuit (O'Neill case) where the investment management fees were not subjected to the 2% limitation.

There have been several recent court cases whereby the Internal Revenue Service took the position that investment management fees paid from a trust are deductible only to the extent they exceed 2% of the adjusted gross income of the trust. The Tax and Appellate Courts in the Second Circuit (Rudkin), the Fourth Circuit (Scott), and in the Federal Circuit (Mellon), each ruled in favor of the IRS. Generally, we have been advised that the tax filings for trust accounts subject to these Circuit Courts should be prepared consistent with the rulings. It is our understanding that the residence of the trustee determines which Circuit Court has jurisdiction.

For the purpose of determining residence, the principal place of business for JP Morgan Chase Bank, N.A. is located in New York, which is in the Second Circuit. Therefore, if JPMorgan Chase Bank, N.A. is the sole trustee, we ask that beginning in 2006 you follow the IRS position of applying the 2% limitation if there are any applicable expenses. This would also apply if all co-trustees are domiciled in the Second, Fourth, or Federal Circuits.

However, if there are any co-trustees that reside outside the Second, Fourth, or Federal Circuits, we ask that for 2006 you do not apply the 2% limitation if there are any applicable expenses.

For your records, the affected Circuit Courts include the following states –
Second – New York, Connecticut, and Vermont

Fourth – Maryland, North Carolina, South Carolina, Virginia, and West Virginia
Federal – District of Columbia and Foreign

We will continue to monitor legislative and judicial decisions with regard to the IRS' position on the deductibility of these and other expenses, and will let you know of any significant changes that will impact the preparation of our tax returns.

Also enclosed is a spreadsheet containing a list of the accounts for which you will be preparing the income tax return. Please note that in the column labeled **"Subject to 2% AGI Reduction 3rd Party Investment Fee"**, we have indicated with a "Yes" those accounts we have determined to be subject to the 2% limitation.

If you have any questions or need additional information, feel free to contact me.

Sincerely,

/s/_____
A. Dean Theiss, Jr.

Enclosures

**IRS Circular 230 Disclosure:**
*JPMorgan Chase Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including attachments) is not intended or written to be used, and cannot be used,, in connection with the promotion, marketing, or recommendation by anyone unaffiliated with JP Morgan Chase Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties.*

"JPMorgan Private Bank" is the marketing name for the private banking and brokerage activities conducted by J.P. Morgan Chase & Co. and its subsidiary banks and broker/dealers.

Supreme Court, U.S.
FILED
MAY 25 2007
OFFICE OF THE CLERK

(3)

No. 06-1286

# In the Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

PAUL D. CLEMENT
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## QUESTION PRESENTED

Whether investment-advice fees incurred by a trust are not costs "which would not have been incurred if the property were not held in such trust," within the meaning of 26 U.S.C. 67(e)(1), and consequently are deductible from gross income under 26 U.S.C. 67(a) only to the extent that they exceed 2% of the trust's adjusted gross income.

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# In the Supreme Court of the United States

No. 06-1286

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

**BRIEF FOR THE RESPONDENT IN OPPOSITION**

## OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 467 F.3d 149. The opinion of the Tax Court (Pet. App. 20a-30a) is reported at 124 T.C. 304.

## JURISDICTION

The judgment of the court of appeals was entered on October 18, 2006. A petition for rehearing was denied on January 19, 2007 (Pet. App. 31a-32a). The petition for a writ of certiorari was filed on March 23, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. In computing the amount of income subject to tax, both individuals and trusts are entitled to subtract cer-

tain "itemized" deductions from their adjusted gross income. See 26 U.S.C. 63 (2000 & Supp. IV 2004). In the case of individuals, 26 U.S.C. 67(a) defines a subset of itemized deductions called "miscellaneous itemized deductions," which are deductible "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." That limitation is often referred to as the "2% floor." Fees paid for investment advice are deductible, see 26 U.S.C. 212; 26 C.F.R. 1.212-1(g), but are miscellaneous itemized deductions subject to the 2% floor, see 26 C.F.R. 1.67-1T(a)(1)(ii).

The 2% floor also applies to trusts, with limited exceptions. Under 26 U.S.C. 67(e)(1), "deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate * * * shall be treated as allowable" without regard to the 2% floor.

2. Petitioner is a multi-generational trust that was established in 1967 under the will of Henry A. Rudkin and was funded with proceeds from the sale of the Pepperidge Farm baked-goods company to the Campbell Soup Company. Pet. App. 21a. The beneficiaries are Henry's son, William, and William's descendants. *Id.* at 21a, 35a-36a. The will gave petitioner's fiduciaries broad powers to invest petitioner's assets, and it authorized them to seek outside advice in making those investments. *Id.* at 21a-22a, 38a, 41a.

At the beginning of 2000, petitioner had approximately $2.9 million in assets. Pet. 6. That year, it paid Warfield Associates, Inc., $22,241 for investment-management advice. Pet. App. 22a. On its fiduciary income tax return for 2000, petitioner deducted, in full, the fees that it had paid to Warfield for investment advice. *Ibid.*

After an audit, the Commissioner allowed petitioner to deduct the investment-advice fees only to the extent that they exceeded 2% of petitioner's adjusted gross income, resulting in a tax deficiency of $4448. *Ibid.*

Petitioner sought review of the asserted deficiency in the Tax Court. It relied on *O'Neill* v. *Commissioner*, 994 F.2d 302 (1993), rev'g 98 T.C. 227 (1992), in which the Sixth Circuit held that investment-management fees paid by a trustee are covered by the exception in Section 67(e)(1). The *O'Neill* court reasoned that because a trustee has a fiduciary duty under state law to manage assets prudently, fees for investment advice are necessary to the trust's administration. Although individual investors can incur similar costs, "they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* at 304.

In response, the Commissioner cited *Mellon Bank, N.A.* v. *United States*, 265 F.3d 1275 (2001), in which the Federal Circuit rejected *O'Neill* and held that expenses are fully deductible only if they are "unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1281. Since investment advice and management fees "are commonly incurred outside of trusts," they are not covered by Section 67(e)(1), and they are subject to the 2% floor. *Ibid.* The Fourth Circuit has reached the same conclusion as the Federal Circuit. See *Scott* v. *United States*, 328 F.3d 132, 140 (2003) ("Because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the 2% floor created by [Section] 67(a).").

3. The Tax Court upheld the deficiency. Pet. App. 20a-30a. It concluded that the construction of Section 67(e) that it had set forth in *O'Neill*, 98 T.C. at 230-231,

"remain[ed] sound." Pet. App. 29a. The court rejected the Sixth Circuit's approach and instead agreed with the position of the Commissioner, consistent with its own precedent and with the precedents of the Federal Circuit in *Mellon Bank* and the Fourth Circuit in *Scott*, that Section 67(e)(1) allows full deductibility only for expenses that are not commonly incurred outside of the trust setting. Pet. App. 26a-29a. Because investment-advice fees are commonly incurred by individuals in managing their own investments, the Tax Court held that they are subject to the 2% floor. *Id.* at 27a, 30a.

4. The court of appeals affirmed. Pet. App. 1a-19a. The court rejected the Sixth Circuit's position, and reached the same result as the Fourth and Federal Circuits through a slightly different reading of the statute. Consistent with the reasoning of the Fourth and Federal Circuits, the court of appeals explained that "the statutory language directs the inquiry toward the counterfactual condition of assets held individually instead of in trust," but it "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." *Id.* at 11a. Instead, "the statute sets an objective limit on the availability of a full deduction." *Id.* at 12a. "[A]s the source of that limit," however, the court stated that Section 67(e)(1) "looks to those costs that individual property owners are capable of incurring." *Ibid.* Since investment-advice fees are costs that individuals can incur, they are subject to the 2% floor even when incurred by a trust. The court explained that this analysis differed from that of the Fourth and Federal Circuits because it did not require an inquiry into whether a given cost is "customarily" or "commonly"

incurred by individuals, but only into whether it could have been incurred by an individual. *Ibid.*

## ARGUMENT

Petitioner observes (Pet. 14-19) that there is a conflict among the circuits concerning the applicability of 26 U.S.C. 67(e)(1) to investment-advice fees paid by a trust. That conflict, however, does not require resolution by this Court because it is likely to be resolved by new regulations interpreting Section 67(e)(1). The judgment of the court of appeals is correct and does not warrant further review.

1. a. The Internal Revenue Service (IRS) presently intends to issue a regulation resolving the question whether investment-advice fees incurred by a trust or estate are subject to the 2% floor of Section 67(a). As part of its *2006-2007 Priority Guidance Plan* (PGP), the IRS listed the issuance of "[g]uidance under section 67 regarding miscellaneous itemized deductions of a trust or estate" as a goal for the 2006-2007 time period. Office of Tax Policy & Internal Revenue Serv., Department of the Treasury, *2006-2007 Priority Guidance Plan* 15 (last modified Mar. 12, 2007) <http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf>. The PGP is a public announcement that identifies the published guidance that the Department of the Treasury and the IRS intend to issue each year to address significant issues in federal tax law. The 2006-2007 PGP, issued on August 15, 2006, "establish[ed] the guidance that the Treasury Department and the Service intend to issue from July 1, 2006, through June 30, 2007." I.R.S. Notice 2006-36, 2006-15 I.R.B. 756. The PGP's inclusion of guidance resolving the existing uncertainty over the interpretation of Section 67 demonstrates that the IRS and Treasury recognize the importance of the issue to taxpayers and tax

administration and intend to commit resources to resolving it.

In accordance with the PGP, the process of preparing a notice of proposed rulemaking addressing the question at issue in this case is currently underway. The Treasury Department and the IRS are reviewing a draft of the notice of proposed rulemaking and plan to complete a staff-level review this month. By early June, the IRS intends to submit a final draft of the notice of proposed rulemaking for formal clearance through IRS Counsel, the IRS Commissioner's office, and Treasury. Treasury and the IRS anticipate that, barring substantive or policy-level objections, the notice of proposed rulemaking should clear agency review and be ready for publication in the Federal Register by July 2007.

b. A regulation interpreting Section 67(e)(1) would resolve the conflict among the courts of appeals without the need for this Court's intervention. As we explain below, the decision of the court of appeals in this case represents a valid interpretation of the statute. Nevertheless, the opinions of the other courts that have considered the issue demonstrate that the statute is susceptible to different interpretations. Under *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837 (1984), a court would be required to defer to the agency's reasonable interpretation.

In particular, if the IRS were to issue a regulation adopting the interpretation of Section 67(e)(1) embraced by the court of appeals below, that regulation would be controlling even in the Sixth Circuit. As this Court has held, a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous

terms of the statute and thus leaves no room for agency discretion." *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 982 (2005). Although the Sixth Circuit in *O'Neill* read Section 67(e)(1) to allow trusts to deduct investment-advice fees without regard to the 2% floor, it nowhere suggested that its reading was compelled by the unambiguous language of the statute. See 994 F.2d at 304. The *O'Neill* decision therefore would not be an obstacle to reconsideration of the issue in light of the agency's contrary views expressed in a regulation issued in the exercise of authority delegated to the agency by Congress.

To be sure, the Fourth and Federal Circuits have adopted a slightly different interpretation from that of the court of appeals below, and both of those courts suggested that the statutory language was unambiguous. See *Scott*, 328 F.3d at 139; *Mellon Bank*, 265 F.3d at 1280. Thus, it is theoretically conceivable that a regulation adopting the view of the court of appeals below might not be accepted by the Fourth and Federal Circuits. But that hypothetical possibility is not a reason to grant review in this case.

As an initial matter, although both the Fourth and Federal Circuits described Section 67(e)(1) as unambiguous, it is not clear that they intended that description to apply to the precise issue on which the court of appeals in this case departed from their analysis. See *Mellon Bank*, 265 F.3d at 1280 ("[S]ection 67(e)(1) unambiguously establishes two requirements for expenditures to qualify for exclusion from the two percent floor."); see also *Scott*, 328 F.3d at 139. In any event, to the extent that there is an abstract difference in the approaches taken by the Fourth and Federal Circuits on the one hand, and the court below on the other, that dif-

ference has little or no practical significance. The Fourth and Federal Circuits have held that Section 67(e)(1)'s exception to the 2% floor applies only to expenses "not customarily incurred outside of trusts," *Mellon Bank*, 265 F.3d at 1281; see *Scott*, 328 F.3d at 129, whereas the court of appeals below held that the exception covers only expenses that "could not have been incurred if the property were held by an individual," Pet. App. 12. But all three courts have held categorically that the exception does not include investment-advice fees incurred by a trust, the only context in which the circuit conflict has arisen. See *Scott*, 328 F.3d at 140 ("[I]nvestment-advice fees * * * are subject to the 2% floor."); *Mellon Bank*, 265 F.3d at 1281 ("Investment advice and management fees * * * are *not* exempt under section 67(e)(1)."). Pet. App. 12a ("We thus join the Federal and Fourth Circuits in holding that [Section] 67(e)(1) does not exempt from [Section] 67(a)'s two-percent floor investment-advice fees incurred by trusts."). There is no basis for speculating that there may be some other type of expenses to which these courts might afford different treatment. If such a concrete conflict were to arise, the Court could address it in a future case. At this time, however, there is no need for this Court to address a hypothetical future conflict concerning the validity of a regulation that has not yet been issued.

2. Petitioner asserts (Pet. 23) that "the construction given the statute below is clearly in error." That is incorrect. In fact, the court of appeals reasonably interpreted the statutory language, giving effect to every part of Section 67(e)(1). The initial text of Section 67(e) establishes the general rule that the adjusted gross income of a trust is to be computed in the same manner as

the adjusted gross income of an individual. Under that rule, the miscellaneous itemized deductions of a trust are subject to the 2% floor of 26 U.S.C. 67(a). Section 67(e)(1) then provides an exception to the general rule, allowing the deduction, without regard to the 2% floor, of costs (i) "which are paid or incurred in connection with the administration of" a trust, and (ii) "which would not have been incurred if the property were not held in such trust."

The first clause requires that the costs be "paid or incurred in connection with the administration of the * * * trust." 26 U.S.C. 67(e)(1). That clause employs the indicative mood, and it asks the simple, objective question whether a cost is related to, associated with, or otherwise linked to the administration of a trust. See *Mellon Bank*, 265 F.3d at 1280. The first clause thus separates trust-related administrative expenses from other trust expenses and from similar expenses incurred by individuals. There is no dispute that fees paid for advice in investing trust assets satisfy the first clause. See Pet. App. 6a.

The second clause states that the costs must be costs "which would not have been incurred if the property were not held in such trust." 26 U.S.C. 67(e)(1). In keeping with the canon that statutes should, whenever possible, be interpreted to give effect to all their terms, the second clause is best read as doing something more than merely separating trust-related administrative costs from other trust-related expenses (and from administrative expenses incurred by individuals). See *Duncan* v. *Walker*, 533 U.S. 167, 174 (2001). Instead, it is a "filter" for determining which trust-related administrative costs are exempt from the 2% floor. *Mellon Bank*, 265 F.3d at 1280-1281; see Pet. App. 11a-12a;

*Scott*, 328 F.3d at 140. The second clause, moreover, is in the subjunctive mood, suggesting that, as the court of appeals observed, it "focuses the inquiry * * * on the hypothetical situation where the assets are in the hands of an individual." Pet. App. 11a; *Scott*, 328 F.3d at 140 (the second clause "asks whether costs are commonly incurred *outside* the administration of trusts").

The courts of appeals that have upheld the application of the 2% floor for investment-advice fees incurred by trusts have construed the verb "would" in the second clause somewhat differently, but, as discussed above, the differences in their approach do not affect the proper categorization of investment-advice fees incurred by trusts. The Fourth and Federal Circuits treat the verb "would" as expressing such concepts as custom, habit, natural disposition, or probability. Under that construction, the second clause makes fully deductible only those trust-related administrative expenses that are not natural, customary, or probable outside of the context of trusts. *Scott*, 328 F.3d at 139-140; *Mellon Bank*, 265 F.3d at 1281. The court below, on the other hand, took a "more restrictive" approach to the meaning of the second clause, limiting full deductibility to costs that individuals are incapable of incurring. Pet. App. 12a. As the court of appeals saw it, a full deduction is permitted "only for those costs that could not have been incurred by an individual property owner." *Id.* at 13a.

Despite their slightly different approaches to the second clause of Section 67(e)(1), the Second, Fourth, and Federal Circuits are in agreement regarding the proper tax treatment of common trust expenses such as fees for investment advice. Because individuals can—and commonly do—pay for professional investment advice, investment-advice fees are subject to the 2% floor

when paid by a trust. Pet. App. 12a, 19a; *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281. On the other hand, trustee fees and the costs associated with judicial accountings and the preparation of fiduciary income tax returns are expenses peculiar to trust administration and would escape the floor. Pet. App. 12a; *Scott*, 328 F.3d at 140.

Despite petitioner's assertion to the contrary (Pet. 28), there is no lack of "consisten[cy]" in this regard. Fully deductible costs are those that are either unique to the fiduciary context (such as trustee fees) or that constitute additional sums that would not have been incurred had there not been a fiduciary arrangement (such as the extra cost of preparing a fiduciary income tax return in addition to the cost of preparing individual income tax returns). Unlike the cost of financial advice, which can be—and often is—incurred by individuals, those fiduciary costs are fully deductible because they would not have been incurred if the property were not held in trust.

3. Petitioner relies on legislative history (Pet. 3, 9) in support of its assertion that Congress enacted 26 U.S.C. 67(e) to give preferential tax treatment to trusts. Petitioner is mistaken. In enacting the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, Congress sought to increase the fairness, simplicity, and economic efficiency of the tax system, largely by closing loopholes and reducing marginal rates in order to make economically inefficient tax-avoidance schemes less attractive. H.R. Rep. No. 426, 99th Cong., 1st Sess. 54-61 (1985); see S. Rep. No. 313, 99th Cong., 2d Sess. 3-8 (1986). Those goals are reflected in the 2% floor of 26 U.S.C. 67(a) and in amendments to other Code sections governing the taxation of trusts. Section 67(a), Congress be-

lieved, would relieve taxpayers of the burden of record-keeping unless they anticipated miscellaneous expenditures in excess of the floor. H.R. Rep. No. 426, *supra*, at 109-110; S. Rep. No. 313, *supra*, at 78-79. Congress also sought to reduce the tax benefit of placing assets in trust in order to split income between the trust and its beneficiaries, primarily by setting the tax rates for trusts so that little income could be sheltered at the lower rates. See 26 U.S.C. 1(e); S. Rep. No. 313, *supra*, at 867-868. Making the 2% floor for miscellaneous itemized deductions applicable to trusts (with an exception for trust-related administrative expenses that would not have been incurred if the property were not held in a trust) also serves that goal by preventing trusts from fully deducting the same expenses that individuals cannot fully deduct. See *Scott*, 328 F.3d at 138-140; *Mellon Bank*, 265 F.3d at 1281; see also *Mellon Bank, N.A.* v. *United States*, 47 Fed. Cl. 186, 193-194 (2000). Thus, subjecting investment-advice fees to the 2% floor is consistent with the intent of Congress underlying the 1986 reforms.

Petitioner contends (Pet. 24-25) that Congress's sole focus in enacting the second clause of 26 U.S.C. 67(e)(1) was to prevent trusts from fully deducting expenses passed down to them from pass-through entities, such as partnerships and nonpublic mutual funds. As the court of appeals explained, however, a study of the bills and committee activity leading to the current version of 26 U.S.C. 67(e) does not support petitioner's interpretation of the statute. See Pet. App. 14a-18a. Although Congress was concerned about taxpayers using pass-through entities to avoid the 2% floor, it could have drafted the second clause of Section 67(e) much more narrowly had that been its only concern. For example,

as the court of appeals hypothesized, Congress could have limited full deductibility to those administrative costs "which are not pass-through costs restricted under section 67(c)." Pet. App. 18a. Instead, Congress chose the broader clause "which would not have been incurred if the property were not held in such trust or estate." That language subjects the cost of investment advice incurred by trusts and estates to the 2% floor—just as if that cost had been incurred by an individual.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

# Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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The Solicitor General agrees that there is "a conflict among the circuits concerning the applicability of 26 U.S.C. 67(e)(1) to investment-advice fees paid by a trust," and acknowledges "the importance of the issue to taxpayers and tax administration." Brief for the Respondent in Opposition ("Opp.") 5. He thus does not dispute that the requirements for certiorari are met here. See S. Ct. R. 10(a). The only reason he gives why certiorari should not be granted is that it is possible that the Treasury Department will at some point in the future issue some kind of regulation. The Government's consistent position, including below, has been that § 67(e) is unambiguous, leaving no room for regulatory action interpreting it or for *Chevron* deference. See Br. for Appellee below at 26; *Chevron USA, Inc. v. NRDC*, 467 U.S. 837 (1984). The Solicitor General now argues, though, that a regulation would "likely" resolve the need for review here because under *National Cable & Telecomms. Ass'n v. Brand X Internet Services*, 545 U.S. 967, 982-983 (2005), reasonable regulations due *Chevron* deference can trump prior Court of Appeals constructions of statutory language so long as those courts have not held the statutory language "unambiguous." He candidly acknowledges that there is not even a "final draft" of a regulation and that "staff-level review" is not yet complete. Opp. 6. He does not provide the text even of the nonfinal draft regulation he asserts is under review.

First, because interpretive tax regulations do not receive *Chevron* deference, and because courts on different sides of the Circuit split here have in any event held the statutory language unambiguous, no regulation could resolve under *Brand X* the issue that divides the Circuits in this case. Second, it is not the practice of this Court to deny certiorari based on the mere potential that anticipated action by some other branch will affect the need for review. *See, e.g., Gonzales v. Duenas-Alvarez*, 127 S. Ct. 35 (2006) (granting certiorari in the face of pending legislation that would have resolved the issue presented); *Rush Prudential HMO, Inc. v. Moran*, 533 U.S. 948 (2001) (same); *Thomas v. Outboard*

*Marine Corp.*, 479 U.S. 811 (1986) (same). That is especially true where, as here, the supposedly problem-solving regulation has not even been finally drafted.

**I. No Regulation Could Resolve the Need for Review Here**

**A.** The Solicitor General's argument (Opp. 6.) is premised upon an as-yet-unwritten final regulation "interpreting Section 67(e)(1)." But such a regulation would not affect the need for review here. What the Solicitor General posits is an interpretive tax regulation. Such regulations are not given *Chevron* deference by this Court, but are measured under the weaker *National Muffler* standard of deference. *Boeing Co. v. U.S.*, 537 U.S. 437, 448 (2003) (citing *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 560-561 (1991), in turn citing *National Muffler Dealers Assn.* v. *U.S.*, 440 U.S. 472, 476-477 (1979)); see Salem, *et al.*, *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717, 761-763 (2004) (Court adheres to *National Muffler* rather than *Chevron* in cases involving interpretive tax regulations). As *Brand X* makes clear, judicial decisions are unaffected by subsequent "agency interpretations to which *Chevron* is inapplicable." 545 U.S. at 983. Even if Respondent's hypothesized regulation were promulgated, the differing decisions of the Courts of Appeals on the question presented would thus under *Brand X* "remai[n] binding law" in their respective Circuits. *Id.* The Circuit split would be unaffected, s would the need for review.

**B.** Further, even a regulatory construction of § 67(e) due *Chevron* deference could not resolve *this* Circuit conflict. As the Solicitor General describes (Opp. 7), the conflicting decisions of the Second Circuit below, on the one hand, and the Fourth and Federal Circuits, on the other, all found the language of § 67(e) "unambiguous." *See* Pet. App. 15a; *Scott v. United States*, 328 F.3d 132, 139 (CA4 2003).[1] Under *Brand X*, "A precedent holding a statute to be unambigu-

[1] It is clear, contrary to the Solicitor General's suggestion (Opp. 7), that the Fourth Circuit found no ambiguity in the relevant statutory language, since it refused for that reason to consult its legislative history.

ous forecloses a contrary agency construction." *Brand X*, 545 U.S. at 984. Thus, even if *Chevron* deference were appropriate, no regulation construing § 67(e) could resolve the conflict here. As Respondent essentially concedes (Opp. 7-8), these divided Circuits at least would remain bound to their constructions of the statutory language they found unambiguous.[2]

Respondent argues that the split between the court below and the Fourth and Federal Circuits is of "little or no practical significance." Opp. 8. To the contrary, there is an enormous difference between their two standards; it is dispositive of this appeal and implicates a wide range of trust expenses from investment expenses to accounting and attorney fees. Petitioner argued below that he was entitled to the full deduction for his investment advice expenses even under the Fourth and Federal Circuits' *Scott/Mellon Bank* test because those costs are not of a type "commonly" incurred by individuals. See Pet. 27, 29. The Second Circuit did not reach this issue because it adopted its "more restrictive" reading of the statute to permit full deductibility by trusts only of administrative costs that could not be incurred by an individual. Even if Respondent's hypothetical regulation would be due *Chevron* deference it could not eliminate the issue in this case or affect the need for review.[3]

**II. This Court's Practice is Not to Deny Otherwise Appropriate Review Because of the Mere Potential For Resolution of the Need for Review By Another Branch**

Of course, more basically, there is no regulation or even a final draft of one here. The words of counsel in a parallel circumstance seeking cert. in *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355 (2001), are apt:

[2] And, indeed, there is no indication that the Sixth Circuit found any ambiguity in the statutory language either. See *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993).

[3] A regulation "adopting the interpretation of Section 67(e)(1) embraced . . . below" (Opp. 6) would be unreasonable, and thus for a second reason not entitled to *Chevron* deference. Whatever ambiguity § 67 may have, it is clear the word "would" does not mean "could." Pet. 23-24.

> The Solicitor General agrees that there is a stark conflict between the circuits . . . and that th[e] question [presented] "is an important one." . . . Yet the Solicitor General recommends against a grant of certiorari because legislative proposals pending in Congress might—if passed and signed by the President—forestall the need for review here. This Court should not stay its hand in favor of the mere *potential* for legislative resolution of this critical question, over which the circuits are in conflict *now*. . . .
>
> This Court typically turns aside the suggestion that it should not decide an issue of national import in a case that satisfies the stringent requirements for certiorari, *see* S. Ct. Rule 10(a), simply because Congress is concurrently considering the issue. *See* Br. for Respondent in *BMW of North America, Inc. v. Gore*, No. 94-896, at 14-15 (noting that "Congress has considered, as part of the legislative debate, virtually all the proposals that BMW and its amici seek to constitutionalize," and that "[t]o date, the House of Representatives and the Senate have each enacted legislation [imposing federal constraints on punitive damage awards] that is being reconciled in conference"). That is an appropriate response. . . . For this Court generally to refrain from deciding issues that Congress may—but may not—address would impede this Court in its historic task of resolving live circuit conflicts such as the one created by the [Court of Appeals's] decision here.
>
> Legislative proposals, even those being "actively consider[ed]" by Congress, Br. for United States at 9, are still just that: proposals. . . . It is also a particularly cavalier response for the Solicitor General to offer, given the very real practical problems the current conflict poses for [those affected by it.] . . .

Supplemental Brief for Petitioner, *Rush Prudential HMO, Inc. v. Moran*, No. 00-1021, at 1-4 (2001).

This Court granted certiorari in *Moran*, and it should do so here. See also, *e.g.*, *Duenas-Alvarez*, 127 S. Ct. 35 (granting certiorari in parallel circumstance though both Houses of Congress had passed language to resolve issue); *Thomas*, 479 U.S. 811 (1986) (granting cert. in parallel circumstance though Conference Committee had agreed on the relevant language to be included in the final bill). The potential for resolution of the conflict here by another branch is at least as speculative as it was there, lying at best several years (and many billions of tax dollars) in the future. Even if a final regulation could resolve the Circuit conflict, the Solicitor General can offer no assurance–and does not purport to–that such a regulation *will* be adopted that *will* address the issue before the Court, or even that a final draft will be produced.

**A. No regulation, or even proposed regulation, has been promulgated and there is no reason to believe any final regulation will address the issue presented here.**

There is no regulation, nor even any proposed regulation, that addresses the meaning of § 67(e). The Treasury Department has not promulgated even an interim or temporary regulation. This statute was passed 21 years ago. The first Court of Appeals ruling rejecting the Commissioner's position was handed down 14 years ago. See *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993). Yet IRS and Treasury staff have not even agreed upon a draft of any relevant regulation.

The Solicitor General does not even assert that any final regulation will actually address the question upon which the Circuits are divided. He says only that "the process of preparing a proposed rulemaking" is "underway." Opp. 6. He notes that the IRS's 2006 Priority Guidance Plan ("PGP") includes among the 264 projects listed as "priorities" for providing further guidance, the provision of "Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate." See Office of Tax Policy & IRS, Department of the Treasury, 2006-2007 PGP at 10 (August 15, 2006). The Solicitor General says that a draft of a notice of pro-

posed rulemaking is being examined by staffers "[i]n accordance with" the PGP. Opp. 6.

To begin with, the PGP is itself only a kind of internal "to do" list for the IRS. Its promulgation is not required and completion of the projects on it is not mandated by law or regulations. There are thus items that have remained on that list unaddressed for many, many years. For example "Regulations under section 529 regarding qualified tuition programs," which is on the current PGP has appeared on every annual list since 1999. Compare Updated 2006-2007 PGP at 9, available at http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf with 1999 PGP at 5, available at http://www.treasury.gov/press/releases/reports/tpplan99.pdf

Second, while the PGP frequently states that what will be provided is "Regulations," with respect to § 67 it states only that "Guidance" will be provided. IRS Guidance can take many forms, including revenue rulings and procedures, notices and technical advice memoranda. The PGP would be satisfied by the issuance of any of these, even if the IRS "presently intends . . . to commit resources" to issuing a regulation. Opp. 5-6. The Solicitor General's argument for denial of course turns upon the hypothetical regulation he posits being entitled to *Chevron* deference. See Opp. 6-7. Even if the regulation he posits would be entitled to that deference, but see *supra*, other forms of IRS guidance are not.

Third, the PGP doesn't say the guidance will address the meaning of § 67(e), nor does the Solicitor General. The PGP says the IRS hopes to issue "Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate." See Updated 2006-2007 PGP at 15. This is a broad topic including other subsections of § 67. A regulation addressing any one of them would satisfy the PGP.[4]

[4] A "proposed regulation" of which Petitioner is aware would satisfy the PGP even though it would have no impact on this case. That regulation is described in an internal IRS Memorandum dated May 10, 2006, that would deal with whether *under § 67(a)* the two-percent floor applies to deductions on the individual income tax returns of beneficiaries receiving income from trusts, *not* with deductions made by trusts *under §*

Most significantly, the Solicitor General *does not even tell this Court what the "draft of the notice of proposed rulemaking" says*, even though the "staff-level review" is said to be scheduled for completion *three business days* after the filing of the Government's Brief in Opposition. Opp. 6. Indeed, the Solicitor General says only that the regulatory process is "[i]n accordance with the PGP," which means it could relate to anything having to do with "miscellaneous itemized deductions of a trust or estate" under any part of § 67. There is thus no evidence – and the Government does not assert – that a regulation is even anticipated that will "adop[t] the interpretation of Section 67(e)(1) embraced by the court below." Opp. 6 (asserting that review would not be necessary "if" such a regulation were adopted).

**B. Any final regulation is likely years away.**

Beyond this, there is all that stands between the Solicitor General's unpresented "draft," Opp. 6, and a properly promulgated final regulation that might be entitled to some deference. First, no text has even been finalized. "Staff-level review" – the lowest level – is itself not yet complete. Because of its internal inconsistencies, see Pet. 28, the Commissioner's position presents a difficult, even impossible, interpretive and thus regulatory problem, one that the IRS has refused to address for decades. The steps between a nonfinal draft and a notice of rulemaking at the IRS are complex. Generally drafts are distributed to 16 types of IRS offices. See Internal Revenue Manual 32.1.6.7.2 available at http://www.irs.gov/irm/part32/ch01s07.html. The procedures at the staff-level include review and comment by all

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*67(e)* on their fiduciary income tax returns. See Reply Brief Appendix 1a (reprinting Memorandum). Respondent does not say this is the proposed regulation to which he refers, but, if adopted, it would be irrelevant to the need for review in this case. Under it the fiduciary tax return filed by a trust itself would be "unchanged," and precisely the same under "current or proposed law." Rep. Br. App. 7a. This case is about how the deduction affects *the Trust's* income (specifically, its capital gains, taxed at the trust level, retained as corpus, and not included in the income distributed to beneficiaries).

affected IRS offices and counsel. *Id.* 32.1.6.7. There are complex disagreement resolution procedures. *Id.* 32.1.6.3. Once a draft is "final," it must be reviewed and approved by a Branch reviewer, an Assistant or Associate Chief Counsel, a Deputy Chief Counsel, the Chief Counsel, the Assistant to the Commissioner, and the Commissioner. *Id.* 32.1.6.8.4. Then it must undergo review anew at Treasury, beginning with an Attorney-Advisor, then the Tax Legislative Counsel, and up through the Assistant Secretary for Tax Policy. *Id.*

More significantly, any proposed regulation would then have to survive notice and comment intact. Notice and comment on tax regulations typically stretches into a several-year process. See, *e.g.*, 26 CFR 1.643(b)-1 (notice of proposed rulemaking issued February 15, 2001, final regulation published January 2, 2004). Sometimes it can take as long as fifteen years. See, *e.g.*, 26 CFR 1.401(a)(9)-1 (notice of proposed rulemaking issued July 27, 1987, final and temporary regulations published April 17, 2002). Adoption of any regulation like the hypothetical one the Solicitor General says would cut against certiorari review here would face enormous opposition from the most important relevant elements of the bar and the financial services industry. The American Bar Association Section on Real Property, Probate and Trust Law on April 28, 2007, adopted a recommendation asking the ABA Board of Governors to pass a resolution urging "that Section 67(e) . . . be interpreted to allow a trust or estate a full deduction from gross income for investment management and advisory fees." Reply Br. App. 10a; see also Brief *amicus curiae* of American Bankers Association, *et al.* 7-13. There is no reason to think (and Respondent does not say) there is a quick regulatory fix here.

**C. There is no adequate basis for denial here.**

As this Court and the Solicitor General have recognized, the likelihood and timing of action by another branch that may affect a case pending before this Court are the significant factors in this Court's determination how to proceed. See, *e.g.*, Petition for Certiorari, *Gonzalez v. Duenas-*

*Alvarez*, 05-1629, at 22 (2006) (successful certiorari petition of Solicitor General arguing that while both Houses of Congress had passed legislation that would have resolved Circuit split and need for review, bill's final passage was "[a]t this point . . . uncertain"); Petition for Certiorari, *Thomas v. Outboard Marine Corp.*, No. 85-1735, at 17 (1996) (same, arguing that although congressional conferees had agreed upon provision that would have resolved the need for review, "prospects for and timing of final passage. . . are . . . uncertain"). The likelihood of a timely or relevant final regulation affecting the split in authority here (even if one could) is even less than the likelihood of timely resolution in cases like *Duenas-Alvarez*, *Moran* or *Thomas*. There, statutory text that would have altered the legal landscape was at least pending before Congress, and would have had immediate effect if enacted into law. This is far more speculative.

The Solicitor General ultimately concedes that his regulation will be issued only "barring substantive or policy-level objections" at the IRS or Treasury Department. Opp. 6. He thus asserts essentially that the IRS and Treasury will issue a regulation if they decide to. And he merely claims that what comes out of the regulatory process will "likely" resolve the issue in this case. Opp. 5. The same could be said in almost any case presenting a split in authority about a statute that is administered by a federal agency.

The Solicitor General knows and has long known what has to be done if the Government is to attempt to employ its regulatory authority to prevent this Court's review of an otherwise certworthy issue. See, *e.g.*, Brief for Respondent, *Mouelle v. Gonzales*, No. 05-1092, at 4 (2006) (Solicitor General Clement) ("DHS and DOJ have . . . 'undertaken to resolve the [circuit] conflict by issuing interim rules, effective [prior to the date of the Brief in Opposition] that repeal [regulations about the validity of which the Circuits are divided]."); Brief for the United States in Opposition, *San Pedro v. United States*, No. 96-40, at 10 (1996) (Acting Solicitor General Dellinger) ("[T]o resolve the uncertainty" cre-

ated by a split among the Circuits concerning the power of a United States Attorney to bind the INS, "the Attorney General . . . issued new regulations" prior to submission of the Brief in Opposition and effective within days thereafter codifying the scope of that power.). Here there is not even a temporary regulation. Even under the pressure of the Solicitor General hoping to avoid review by this Court, the Government has failed to make a credible start. And in failing to provide this Court with the text of any proposed regulation, Respondent deprives it, and Petitioner, of the necessary and appropriate opportunity to evaluate whether and how that regulation would actually affect the issue before the Court.[5]

Finally, it would be particularly inappropriate to deny review on this speculative basis in a case like this. The issue in this case involves billions of dollars annually and recurs constantly. Yet if the Court denies review here, it is not likely to see another case presenting this issue for many, many years. This case presents a classic free rider problem. While the total amount of tax liability is enormous, each taxpayer's is not. Here, for example, $4,448.00 is at issue. The cost of litigation thus far exceeds the economic benefit any individual taxpayer stands to gain. Nonetheless, taxpayers should in coming years be able to deduct the expenses at issue, if that is what is permitted by law. At the same time, the Commissioner deserves a clear ruling if his position is right.[6]

## CONCLUSION

The Petition for Writ of Certiorari should be granted.

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[5] Even if it were possible that a regulation could resolve the division in authority here, which it is not, such a regulation would not eliminate all the reasons review is appropriate. It would not affect Petitioner's case, nor the tax liability of the myriad other taxpayers filing affected returns prior to its effective date. Significantly, Respondent does not claim this is an insignificant category. With expenses each year for investment advice estimated in the billions of dollars, the effect of the decision below on this class alone is enormous.

[6] Respondent does not actually defend the decision below (which rejected his position), arguing only that it is "reasonable." Opp. 8. His merits arguments (Opp. 8-13) are adequately addressed in the Petition.

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# APPENDIX

**APPENDIX A**

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**Washington, D.C. 20224**

SMALL BUSINESS/SELF-EMPLOYED DIVISION

May 10, 2006

**MEMORANDUM FOR CHIEF COUNSEL**

**FROM:** K. Steven Burgess */s/ Monica L Baker*
Director, Examination

Bill Conlon
Director, Specialty Programs

**SUBJECT:** Proposal to Issue Regulations under Internal Revenue Code Section 67 for the 2 Percent Floor on Miscellaneous Itemized Deductions

**Introduction**

The purpose of this memo is to request that regulations be issued under Temporary Treasury Regulation §1.67-4T, entitled "Allocation of expenses by non-grantor trusts and estates (temporary)" which is currently "reserved." This regulation is needed to close a loophole that allows certain individual taxpayers (generally high income) to indirectly claim tax benefits that they cannot directly claim. This loophole not only perpetuates unfairness but also contravenes

Congressional intent and, based on preliminary data, results in sizeable annual losses of tax revenue.

Because the Internal Revenue Service (Service) previously was unable to systemically identify those individuals using the loophole, it had not requested regulations to correct the problem (which has existed since Section 67 was added to the Internal Revenue Code (IRC) in 1986). Now, however, the Service has the capability, through its Schedule K-1 matching program, to systemically identify individuals using this loophole, and the proposed regulations could be enforced.

**Background**

Internal Revenue Code Section 67 limits otherwise allowable miscellaneous itemized deductions for individuals and certain entities to the amount that exceeds 2 percent of adjusted gross income. In applying the 2 percent floor to trusts and estates, adjusted gross income (AGI) is computed in the same manner as in the case of an individual, except that certain deductions are allowed in full. Among these deductions is an "income distribution deduction" (IRC Section 67(e)(3)) that is equal to the amount of income distributed or required to be distributed annually. For a trust that distributes (or is required to distribute) all of its income annually, IRC Section 67(e)(3) operates to significantly reduce or eliminate the trust's AGI, and thereby significantly reduce or eliminate the impact of IRC Section 67(a).

The following example compares the impact of Section 67 on a trust beneficiary with the impact of that section on an individual who holds income-generating assets directly. This example assumes that the trust beneficiary or individual has no other income or deductions.

| **Trust Beneficiary** | |
|---|---|
| Trust income: | 1,000,000 |
| Administrative expenses: | 120,000 |
| Individual distribution deduction: | 880,000 |
| Exemption: | 300 |
| Trust taxable income: | (300) |
| | |
| Investment advisory fees (subject to the 2 percent limitation): | 200,000 |
| Amount of reduction of deduction (i.e., 2 percent of trust taxable income): | 0 |
| Deductible investment advisory fees: | 200,000 |

| **Individual Holding Assets Directly** | |
|---|---|
| Income: | 880,000 |
| Investment advisory fees: | 200,000 |
| Amount of reduction of deduction (i.e., 2 percent of gross income): | 17,600 |
| Deductible investment advisory fees: | 182,400 |

Because of the $880,000 distribution deduction and the $300 exemption, the trust's AGI is $(300). As set forth above, applying the 2 percent limitation on this negative AGI produces no limitation on the miscellaneous deduction. The entire $200,000 is deducted at the trust level and the beneficiary receives and reports income from the trust in the net amount of $680,000. Thus, the trust (and indirectly the beneficiary) is able to claim the entire $200,000 in investment advisory fees as a miscellaneous itemized deduction—even though the fees are theoretically subject to the 2 percent limitation of IRC Section 67. In contrast, the individual holding the assets directly must report $880,000 income and can claim only a miscellaneous itemized deduction of $182,400. As a result, the trust beneficiary can indirectly deduct an additional $17,600 that he would not be

able to deduct if paid directly by him as an individual.[1] Because the limitation of IRC Section 67 is circumvented as a result of the application of distribution deduction, that limitation is also circumvented in complex trusts and estates to the extent that those entities claim distribution deductions.

Internal Revenue Code Section 67(c)(1) provides that "[t]he Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual." Internal Revenue Code Section 67(c)(3)(B) states, however, that the prohibition of indirect deductions shall not apply to estates and trusts "except as provided in regulations." In 1988, the Service issued Temp. Treas. Reg. §1.67-2T, which applies to grantor trusts and a variety of other pass-through entities but does not apply to non-grantor trusts and estates. That regulation permits the specified entities to pass through without reducing the total amount of deduction that would otherwise be subject to the 2

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[1] In addition to §67, §68 reduces the amount of the itemized deductions otherwise allowable for the taxable year for high income taxpayers, while trusts are not subject to §68. Section 68 states that "the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of: 3 percent of the excess of adjusted gross income over the applicable amount, or 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year." Beginning in 2005, the "applicable amount" of adjusted gross income, above which the amount of otherwise allowable itemized deductions reduced is $145,950 (or $72,975 for a separate return filed by a married individual). *See* § 3.11 of Rev. Proc. 2004-71. Thus, the disparity between the deduction available to an individual without a trust and an individual who is the beneficiary of a trust is further increased.

percent floor but requires the beneficiary, partner, S-shareholder or other individual to whom amounts are distributed to apply the 2 percent floor based on his or her own individual adjusted gross income. The regulation designed to address non-grantor trusts and estates, Temp. Treas. Reg. §1.67-4T, entitled "Allocation of expenses by non-grantor trusts and estates (temporary)," is "reserved," but no language has ever been issued. *See* INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES, Byrle M. Abbin (2001 Ed.) section 310 stating "Generally, the 2 percent floor on miscellaneous itemized deductions is to be applied at the fiduciary level. However, IRC Section §67(c) authorizes the Treasury to issue regulations that would apply the 2 percent at the beneficiary level in the case of a simple trust. To date, the Treasury has not exercised its regulatory authority on this matter."

**Discussion**

Internal Revenue Code Section 67(c)(3) expressly states that the prohibition against indirect deductions shall not apply to estates and trusts "except as provided in regulations." Absent language under Temp. Treas. Reg. §1.67-4T, an individual who is a beneficiary of a trust can claim certain deductions in excess of the 2 percent limitation intended by Congress, while a similarly situated individual who holds those same assets directly would be limited by IRC Section 67(c)(1), as well as IRC Section 68.

Internal Revenue Code Section 67 was added to the IRC as part of the Tax Reform Act of 1986. Congress sought to address its concern that "under present law, some taxpayers can exclude or deduct from income certain items that differ little from items that are . . . nondeductible expenditures for other taxpayers." H. Rep. No. 99-426, at 57 (1986). *See Mellon Bank, N.A., Trustee v. United States*, 265 F.3d 1275, 1281 (2001) (addressing the application of the 2 percent floor

to a trust—not its beneficiaries—and observing that the legislative intent of TRA 1986 is to . . . "limit the ability of sophisticated individuals to use trusts or other complex arrangements to lower their tax burden compared to similarly situated individuals.") Moreover, in the House Report to the subsequent Technical Correction Act of 1988 (P.L. 100-647), Congress expressed its expectation that the Service would apply the 2 percent limitation to trust beneficiaries, stating that the bill modifies IRC Sections 67(c) and 67(e) to make clear that "the Treasury has regulatory authority to apply the two-percent floor at the beneficiary level, rather than at the entity level, with respect to trusts required to distribute income currently." S. Rep. No. 100-445, at 12 (1988).

Research information indicates that claiming unlimited miscellaneous deductions may be widespread and involves sizeable amounts. For Tax Year 2002, 983 simple trusts with income greater than $25,000 claimed distribution deductions and miscellaneous itemized deductions and the total amount of miscellaneous itemized deductions claimed by all simple trusts (including those with income less than $25,000) was $275 million. Similarly, for TY 2003, 1,197 simple trusts with income greater than $25,000 claimed distribution deductions and miscellaneous itemized deductions and the total amount of miscellaneous itemized deductions claimed by all simple trusts (including those with income less than $25,000) was $311 million. We do not currently have information to allow us to estimate the amount of the miscellaneous itemized deductions that would be eliminated through promulgation of the proposed regulation. A recently completed Compliance Initiative Project (CIP) reviewed 137 simple trust TY 2003 returns with the highest incomes that claimed both miscellaneous itemized deductions and distribution deductions. These trusts claimed a total of $245 million in distribution deductions and $49 million in miscellaneous itemized deductions. All of the beneficiaries

associated with analyzed returns failed to report any portion of the miscellaneous itemized deduction and, instead, reported only the net income that they received from the trust. Virtually all of the beneficiaries were high-income taxpayers and the amounts they claimed for other (non-trust) miscellaneous itemized expenses were significantly reduced by the 2 percent limitation of IRC Sections 67 and by §68.

The following example is based on the income and miscellaneous itemized deductions from an actual CIP case. (For simplicity, it does not include other attributes from the tax returns, such as Schedule D, Capital Gains and Losses, information.) It compares the treatment of a trust beneficiary under current law and under the proposed regulations.

***Trust Return (unchanged under current or proposed law; impact on beneficiary will change as shown below)***

- Trust income: 3,159,746
- Misc. expenses: 1,327,990
- Individual distribution deduction: 1,831,756
- Exemption: 300
- Trust taxable income: (300)
- Amount of reduction of misc. itemized deduction (i.e., 2 percent of trust taxable income): 0
- Misc. itemized deduction: 1,327,990

***Individual Return—under current law***

- Taxpayer reports total adj. gross income: 3,243,741
  - 1,831,756 of income from trust
  - 1,411,985 of other income
- Taxpayer misc. expenses 323,269
  (no share of trust misc. expenses)
  (subject to 2 percent limitation)
- Taxpayer's misc. itemized deduction is reduced by (AGI multiplied by 2 percent) 64,875

- Taxpayer reports misc. itemized deduction: 258,394
  (No share of trust misc. deduction)

***Individual Return—under proposed regulation***

- Taxpayer reports total adj. gross income: 4,571,731
  - 3,159,746 of income from trust
  - 1,411,985 of other income
- Taxpayer misc. expenses
  (subj. to 2 percent limit) 1,651,259
  - Trust 1,327,990
  - Non-trust 323,269
- Taxpayer's misc. itemized deduction is
  reduced by (AGI multiplied by 2 percent) 91,435
- Taxpayer reports misc. itemized deduction: 1,559,824
  (No share of trust misc. deduction)

Under the current law, the beneficiary claims directly or indirectly miscellaneous itemized deductions totaling $1,686,385 (i.e., the trust return deduction of $1,327,990 and individual return deduction of $258,394). In contrast, under the proposed regulation, the beneficiary directly claims miscellaneous itemized deductions of $1,559,824—placing him in the same position as a taxpayer who incurs those expenses outside of a trust. (Applying IRC Section 68 would further reduce the allowable itemized deduction.)

The importance of the proper application of IRC Section 67 will likely increase. The courts have begun to clarify that certain types of trust expenses previously not consistently held to be subject to IRC Section 67 are, in fact, subject to that provision. In this regard, one court of appeals had held that investment advisory fees incurred by a trust were not subject to IRC Section 67—even though they would be limited by IRC Section 67 if incurred by an individual. *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993). More recently, however, two other courts of appeals have

held that such trust expenses are properly subject to IRC Section 67. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001). *See also William R. Rudkin Testamentary Trust v. Commissioner*, 124 T.C. 19 (2005) (following the holding of the *Scott* and *Mellon* cases).

**Conclusion**

The IRS is unable to close this loophole without regulations. Closing this loophole would promote tax equity, and advance Congressional intent, as well as advance the first objective listed in the IRS Strategic Plan 2005-2009. That objective is to "Discourage and Deter Non-Compliance with Emphasis on Corrosive Activity by . . . High-Income Taxpayers and Other Contributors to the Tax Gap." (Strategic Plan p. 18-20.) Specifically, it would address two specific priority areas of the objective, i.e., the "underreporting of income by higher income individuals" and "flow-through income." (Id.)

If you have any questions about the issue, please contact Jan Geier, SB/SE Division, Special Counsel, at (202) 283-7661 or Scott Emerson, SB/SE Trust Technical Advisor, at (202) 320-2803.

# APPENDIX B

## AMERICAN BAR ASSOCIATION
## SECTION OF REAL PROPERTY, PROBATE, AND TRUST LAW

## REPORT TO THE HOUSE OF DELEGATES

## RECOMMENDATION

RESOLVED, That the American Bar Association recommends that Section 67(e) of the Internal Revenue Code be interpreted to allow a trust or estate a full deduction from gross income for investment management and advisory fees in arriving at its adjusted gross income, and that these expenses not be subject to the general rule of Section 67(a), which allows miscellaneous itemized deductions only to the extent that the aggregate of those deductions exceeds two percent of adjusted gross income.

Supreme Court, U.S.
FILED
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No. 06-1286

IN THE

# Supreme Court of the United States

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,
*Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE,
*Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## BRIEF OF AMERICAN BANKERS ASSOCIATION AND NEW YORK BANKERS ASSOCIATION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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*May 22, 2007*

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*Petitioner*,
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COMMISSIONER OF INTERNAL REVENUE,
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On Petition for Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

## BRIEF OF AMERICAN BANKERS ASSOCIATION AND NEW YORK BANKERS ASSOCIATION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

The American Bankers Association ("ABA") and the New York Bankers Association ("NYBA") submit this brief as *amici curiae* in support of the petition of William L. Rudkin Testamentary Trusts for a writ of certiorari.[1]

[1] Pursuant to Rule 37.2(a), counsel for the parties has consented in writing (copies of which have been filed with the clerk) to the filing of this brief. Pursuant to Rule 37.6, counsel certifies that no counsel for any party authored this brief in whole or in part, and no person or entity other than the *amici curiae*, its members made a monetary contribution to the preparation or submission of the brief.

## INTEREST OF AMICI CURIAE

The ABA is the largest national trade association of the banking industry in the country. It represents banks and holding companies of all sizes in each of the fifty states and the District of Columbia, including community, regional, and money center banks. The ABA also represents savings associations, trust companies, and savings banks. ABA members hold approximately 95% of the U.S. banking industry's domestic assets. ABA frequently appears in litigation, either as a party or *amicus curiae*, in order to protect and promote the interests of the banking industry and its members.

The NYBA is comprised of over 150 financial institutions, including financial services holding companies, bank holding companies, and community, regional, and money center banks and thrifts in the State of New York. In the aggregate, its members have assets in excess of $3 trillion and over 300,000 New York employees. The NYBA seeks to facilitate the efficient provision of financial services while encouraging the highest possible banking standards.

*Amici* have a direct interest in the outcome of this litigation. Many of ABA's and NYBA's members serve as trustees and executors, or act as agents for individuals who serve as executors or trustees. The issue presently before the Court concerns the proper construction and interpretation of

Section 67(e) of the *Internal Revenue Code* (the "Tax Code"), 26 U.S.C. § 67(e). This statute addresses the taxation of trusts and estates, specifically the deductibility of investment advisory fees.

As the Court is aware, there is currently a split among the circuits regarding the extent to which investment advisory fees are deductible. In this case, the Second Circuit disallowed an "above-the-line" deduction under 26 U.S.C. § 67(e) for investment advice and management fees incurred by a trustee in the exercise of his or her fiduciary duties and responsibilities. The United States Court of Appeals for the Sixth Circuit, however, previously reached the opposite result, ruling that fees for investment management are fully deductible by trusts.

ABA and NYBA strongly support the petition for review. The nation's tax statutes should be interpreted in a uniform and consistent fashion by the courts; the legal deductibility of an item is one area where there should be no variation among the judicial circuits. ABA and NYBA respectfully submit that it is both necessary and appropriate for the Court to conclusively resolve this dispute between the Internal Revenue Service and providers of trust services regarding the tax treatment of fees incurred by a trustee in the exercise of their fiduciary duties. The division among the circuits threatens to unfairly place the portion of the financial services industry that is located in the Second Circuit – which includes the New York banking center – at a competitive disadvantage.

## ARGUMENT

### A. The Court Should Grant The Petition In Order To Prevent Harm To The Financial Services Industry And Resolve The Conflict Among The Circuits.

The core issue in dispute concerns the deductibility of investment management fees incurred by trustees in carrying out their duties under section 67(e) of the Tax Code, 26 U.S.C. § 67(e). Section 67(e) generally provides that "miscellaneous itemized deductions for any taxable year" are deducted only to the extent "that the aggregate of such deductions exceeds 2 percent of adjusted gross income" of the estate. However, the text of 26 U.S.C. § 67(e) also creates an exception allowing for deduction of trust expenditures without regard to the two-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. 26 U.S.C. § 67(e)(1). Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

The Internal Revenue Service takes the position that, because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the taxpayer could not show that they would not have been incurred if the assets were not held in trust. The Service's position has been the subject of litigation (including this case) with varying outcomes. The Sixth Circuit in *O'Neill v. Commissioner*, 994 F. 2d 302 (6th Cir. 1993), concluded that investment management fees are fully deductible by trusts because they "would not have been incurred if the property had not been held in trust."[2] The Federal Circuit[3] and Fourth Circuit[4] have previously reache

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[2] *O'Neill*, at 304.

[3] *Mellon Bank, N.A. v. United States*, 265 F. 3d 1275, 1281 (Fed. Cir. 2001).

[4] *Scott v. United States*, 328 F. 3d 132, 140 (4th Cir. 2003).

the opposite result, each holding that Section 67(e) of the Tax Code does not permit the full deduction of investment management fees because these expenses are commonly incurred outside of the trust context. Finally, in the decision below, the Second Circuit advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner." [5] Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits,[6] the Second Circuit held that fees paid by trusts and estates for management and investment of assets are never fully deductible.

The existence of a split among the several judicial circuits has created confusion and uncertainty concerning the deductibility of investment advisor fees among ABA's and NYBA's members. In jurisdictions where the issue has not been addressed at the appellate level, it is difficult to predict which result – fully deductible or subject to the two-percent floor – will prevail. Anecdotal evidence suggests that among ABA's and NYBA's members this uncertainty has led to inconsistent tax treatment of these fees by the taxpayer.[7]

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[5] *William L. Rudkin Testamentary Trust v. Commisioner of Internal Revenue*, 467 F.3d 149, 160 (2nd Cir. 2006).

[6] *Id.*

[7] These inconsistencies in approach are also confusing for trust beneficiaries, who may not fully understand why one trustee would take one position while another trustee would take a different position. This has serious significance for ABA and NYBA members who serve as trustees and executors or their agents. Resolving these different outcomes in different circuits is vital to the smooth functioning of the law.

These variations in the treatment of trust beneficiaries among ABA's and NYBA's members reflect the inconsistencies in the interpretation of the tax code among the different federal jurisdictions, highlighting that, while this conflict endures, taxpayers in identical circumstances living in different jurisdictions can and will face different federal tax obligations.

In addition to the fundamental lack of fairness created when the nation's tax laws are not applied uniformly, the disparity in tax burden created by an inconsistent application of the Tax Code results in a competitive disadvantage for institutions located within the jurisdictions that do not allow full deductibility for investment advisor fees. In the present case, institutions offering trust services that are located within the Second Circuit -- which includes the New York banking center – may become less attractive to their clientele who seek trust services. Customers for these services will quickly recognize that their estate will be subjected to a larger annual federal tax "bite" if it is managed by a fiduciary located in New York than if it were managed by a firm located in a more taxpayer-friendly jurisdiction. This dollars-and-cents disadvantage could have serious consequences for the financial services industry in New York as trustees, settlors and beneficiaries seek ways to avoid the fallout from the Second Circuit's decision. The impact of this competitive disadvantage could extend beyond a reduction in trust business as financial services companies are typically chosen both to serve as trustees and to provide management and advisory services for those trusts; individual trustees typically obtain investment management and advisory services from financial services companies from within the jurisdiction, particularly in New York.

ABA submits that the issues presented in this case are of immense practical importance to ABA's members and the

banking industry as a whole. The aggregate amounts at stake in the resolution of this dispute are enormous, and the existence of a split in the law on this issue strongly indicates that both bench and bar require the guidance of this Court.

### B. The Decision Below Was Decided Incorrectly.

The ABA and the NYBA respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities.

It is the existence of this legal duty of prudence that differentiates the individual investor from the trustee. Trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help. Unlike trustees, individual investors are

> not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

*O'Neill*, 994 F.2d at 304. The Sixth Circuit found persuasive the existence of a legal duty to potentially seek out and incur costs for investment advice when it concluded that trusts' investment management fees are fully deductible under

Section 67(e) of the Tax Code since they "would not have been incurred if the property had not been held in trust."[8]

This legal duty of prudence has been embodied and codified in the Uniform Prudent Investor Act ("UPIA"). Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 43 states as the standard for trust investment law,[9] including Connecticut and New York.[10]

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[8] *O'Neill,* at 304.

[9] Forty-three states have adopted the Uniform Prudent Investor Act: Alaska Stat. §§ 13.36.225 – 13.36.290 (West, Westlaw through 2004 Sess.); Ariz. Rev. Stat. Ann. §§ 14-7601 – 14-7611 (West, Westlaw through 2005 Sess.); Ark. Code Ann. §§ 24-2-610 – 24-2-619 (West, Westlaw through 2005 Sess.); Cal. Prob. Code §§ 16045 – 16054 (West, Westlaw through 2005 Sess.); Colo. Rev. Stat. Ann. §§ 15-1.1-101 – 15-1.1-115 (West, Westlaw through 2005 Sess.); D.C. Code Ann. §§ 19-1309.01 – 19-1309.06 (West, Westlaw through Sept. 13, 2005); Fla. Stat. Ann. §§ 518.11, 518.112 (West, Westlaw through 2005 First Sess.); Haw. Rev. Stat. §§ 554C-1 – 554C-12 (West, Westlaw through 2004 Sess.); Idaho Code §§ 68-501 – 68-514 (West, Westlaw through 2005 Sess.); Ill. Ann. Stat. ch. 760, para. 5/5, 5/5.1 (West, Westlaw through 2005 Sess.); Ind. Code Ann. §§ 30-4-3.5-1 – 30-4-3.5-13 (West, Westlaw through 2005 First Sess.); Iowa Code Ann. §§ 633.4301 – 633.4310 (West, Westlaw through 2005 First Sess.); Kan. Stat. Ann. §§ 58-24a01 – 58-24a19 (West, Westlaw through 2004 Sess.); Me. Rev. Stat. Ann. tit. 18-B §§ 901 – 908 (West, Westlaw through 2005 First Sess.); Md. Code Ann., Est. & Trusts §§ 14-405(c), 15-114(b) West, Westlaw through (2005 Sess.); Mass. Gen. L. c. 203C, §§ 1 – 11 (West, Westlaw through

(...continued)

(...continued)
2005 First Sess.); Mich. Comp. Laws §§ 700.1501 – 700.1512 (West, Westlaw through 2005 Sess.); Minn. Stat. Ann. §§ 501B.151, 501B.152 (West, Westlaw through 2005 First Special Sess.); Mo. Ann. Stat. §§ 469.900 – 469.913 (West, Westlaw through 2005 First Extraordinary Sess.); Mont. Code Ann. § 72-34-601 – 72-34-610 (West, Westlaw through 2005 Sess.); Neb. Rev. Stat. §§ 30-3883 – 30-3889 (West, Westlaw through 2005 First Sess.); Nev. Rev. Stat. §§ 164.705 – 164.775 (West, Westlaw through 2004 Special Sess.); N.H. Rev. Stat. Ann. §§ 564-B:9-901 – 564-B:9-906 (West, Westlaw through 2005 Sess.); N.J. Stat. Ann. §§ 3B:20-11.1 – 3B:20-11.12 (West, Westlaw through 2005); N.M. Stat. Ann. §§ 45-7-601 – 45-7-612 (West, Westlaw through 2005 First Sess.); N.C. Gen. Stat. Ann. §§36A-161 – 36A-173 (West, Westlaw through 2005 Sess.); N.D. Cent. Code §§ 59-02-08.1 – 59-02-08.11 (West, Westlaw through 2005 Sess.); Ohio Rev. Code §§ 1339.52 – 1339.61 (West, Westlaw through 2005 Sess.); Okla. Stat. Ann. tit. 60 §§ 175.60 – 175.72 (West, Westlaw through 2005 First Extraordinary Sess.); Or. Rev. Stat. §§ 128.192 – 128.218 (West, Westlaw through 2003 Sess.); 20 Pa. Cons. Sta. Ann. §§ 7201 – 7214 (West, Westlaw through 2005-58); R.I. Gen. Laws §§ 18-15-1 – 18-15-13 (West, Westlaw through Jan. 2004 Sess.); S.C. Code Ann. § 62-7-933 (West, Westlaw through 2005 Sess.); S.D. Codified Laws Ann. §§ 55-5-6 – 55-5-16 (West, Westlaw through 2005 Special Sess.); Tenn. Code Ann. §§ 35-14-101 – 35-14-114 (West, Westlaw through 2005 First Sess.); Tex. Prop. Code Ann. §§ 117.001 – 117.012 (West, Westlaw through 2005 2nd Sess.); Utah Code. Ann. §75-7-901 – 75-7-907 (West, Westlaw through 2005 First Special Sess.); Vt. Stat. Ann. tit. 9, §§ 4651 – 4662 (West, Westlaw through 2005 First Sess.); Va. Code Ann. §§ 26-45.3 – 26-45-14 (West, Westlaw through 2005
(...continued)

The UPIA provides, in part that a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[11] These "other circumstances" that a trustee must take into consideration when executing this duty as a "prudent investor" include:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; and
- the expected total return from income and the appreciation of capital.[12]

A prudent trustee must consider a trust portfolio as a whole, with an emphasis on what the commentary to the UPIA refers

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(...continued)
Sess.); Wash. Rev. Code Ann. §§ 11.100.010 – 11.100.140 (West, Westlaw through 2005 legislation); W. Va. Code §§ 44-6C-1 – 44-6C-15 (West, Westlaw through 2005 Fourth Ex. Sess.); Wis. Stat. Ann. § 881.01 (West, Westlaw through 2005 Act 25); Wyo. Stat. Ann. §§ 4-10-901 – 4-10-913 (West, Westlaw through 2005 Sess.)

[10] Conn. Gen. Stat. Sec. 45a-541-45a-541*l* (West, Westlaw through 2005 Sess.); N.Y. E.P.T.L. § 11-2.3 (West, Westlaw through 2005 Sess.)

[11] UPIA, Section 2(a).

[12] UPIA, Section 2(c)

to as "the main theme of modern investment practice, sensitivity to the risk/return curve."[13] A trustee must also consider the "other resources" of the beneficiaries, the beneficiary's needs for liquidity, regularity of income, preservation or appreciation of capital, and an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[14]

The UPIA's approach to trust management presents a marked change from many older statutes that allowed a trustee to simply rely on lists of "approved" investments. The commentary to the UPIA observes that the "universe of investment products changes incessantly."[15] The UPIA's commentary cites as an example of this "incessant" change in investment product the fact that equities were at one time thought to be too risky, as more recently were futures.[16] Both are now used in fiduciary portfolios. On the other hand, long-term bonds, once a model trust investment, are now seen to pose a risk of inflation and volatility.[17]

Thus, the task of investing and managing trust assets under the UPIA becomes highly complex. Section 3 of the UPIA requires that a "trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[18] At the same time, a

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[13] UPIA, Section 2, Comment on Risk and return.

[14] UPIA, Section 2(c)

[15] UPIA, Section 2, Comment on Abrogating categorical restrictions

[16] UPIA, Section 2, Comment

[17] UPIA, Section 2, Comment

[18] UPIA, Section 3

strategy that minimizes the taxation incident to portfolio turnover is preferred.[19] In addition, a trustee is required to make a reasonable effort to verify facts relevant to the investment and management of trust assets.[20] Prudent diversification and proper asset allocation may well include investments in asset classes other than high-quality bonds and large capitalization stocks. Trustees may find it necessary to invest in a far broader array of assets including international stocks, international bonds, small capitalization stocks, real estate, timber, venture capital funds, hedge funds or high-yield bonds. Trustees, whether individual or corporate, may not have the expertise at hand to make such investments and will be compelled to embrace an "open architecture" strategy employing one or more third party investment specialists.

Many trustees or fiduciaries would find it daunting – or irresponsible – to take on the complex duty of administering a trust without the help of professional investment assistance. In such cases, the legal duty to act as a "prudent investor" would dictate that a trustee hire one or more investment managers to handle the complexities inherent in modern trust management. Indeed, the drafters of the UPIA anticipated that a prudent trustee will choose to hire an investment manager or seek professional advice in order to ensure the proper management of the assets, and that such a delegation will often benefit the trust beneficiaries.

In sum, the Court should conclude that the Second Circuit decided the case below incorrectly. The existence of a legal duty of prudence differentiates the individual investor

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[19] UPIA, Section 3, Comment

[20] UPIA, Section 2, Comment

from the trustee, and the fulfillment of that duty of prudence may require a trustee to retain expert investment help. The advice received by the trustee (and for which the fees are incurred) is in most cases peculiar to the particular trust in light of the trust's purpose and other factors outlined by the UPIA. The Court should ultimately conclude that investment management fees are fully deductible by trusts under Section 67(e) of the Tax Code because they "would not have been incurred if the property had not been held in trust."

## CONCLUSION

Based upon the foregoing, the ABA and NYBA urge the Court to grant the petition for certiorari to resolve the conflict between the circuits and to provide a uniform interpretation of the Tax Code.

Respectfully submitted,

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*Attorneys for Amicus Curiae American Bankers Association*

*May 22, 2007*

8/23/07

(10)

AMER RECORDS AND BRIEFS

FILED
AUG 23 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 06-1286

IN THE

# Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,
*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent*.

**On Writ of Certiorari to the United States Court of Appeals for the Second Circuit**

## JOINT APPENDIX

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*Petition for Certiorari Filed March 23, 2007*
*Certiorari Granted June 25, 2007*

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**RELEVANT DOCKET ENTRIES**

12/07/05

UNITED STATES TAX COURT
DOCKET ENTRIES

Docket No. 3297-04 INDEX

William L. Rudkin Testamentary Trust U/W/O Henry A. Rudkin, Michael J. Knight, Trustee

v. COMMISSIONER OF INTERNAL REVENUE

| | | |
|---|---|---|
| William L. Rudkin Testamentary Trust U/W/O Henry A. Rudkin Trt C/O Michael J. Knight 116 Sherman St. Fairfield, CT 06824 | CC0618 NO. 1 | (Service Attorney) Cantrell,Carol A. Briggs & Veselka Co. Suite 700 6575 West Loop South Bellaire, TX 77401 |

| NO. | DATE EVENT | FILINGS AND PROCEEDINGS | ACT/STAT DTE SERVED M |
|---|---|---|---|
| 0001 | 02/24/04 PF | PETITION Filed: Fee Paid | R 02/25/04 |
| 0002 | 02/24/04 DPT | DESIGNATION of Trial at Hartford, CT | R 02/25/04 |
| 0003 | 02/25/04 OCA | ORDER that caption of case is amended. | B 02/25/04 |

| | | | |
|---|---|---|---|
| 0005 | 09/15/04<br>O | ORDER set time & date certain 9/21/04 Hartford, CT for trial. | B 09/16/04 C |
| 0006 | 09/20/04<br>TRL | TRIAL before S.T. Judge Goldberg at Hartford, CT | ORD<br>03/21/05 |
| | | Also called 9/21/04. Petr's oral mot. to remove "S"<br>-- See order. Ans.<br>to be filed by 10/21/04 -- No order. | |
| | | RESP'S OPENING BRIEF DUE 12/6/04<br>PETRS' ANSWERING BRIEF DUE 1/5/05<br>RESP'S REPLY BRIEF DUE 2/7/05 | |
| | | SUBMITTED TO S.T. JUDGE GOLDBERG | |
| 0007 | 09/20/04<br>STP | STIPULATION OF FACTS w/Exhs. | |
| 0008 | 09/21/04<br>PTM | PRE-TRIAL MEMORANDUM for resp. (served at session) | |
| 0009 | 09/21/04<br>PTM | PRE-TRIAL MEMORANDUM for petr. (served at session) | |
| 0010 | 09/21/04<br>ODS | ORDER that the letter "S" is deleted from the Dkt. No. oral mot. to delete "S" is Gr. | B 10/13/04 C |



| | | | |
|---|---|---|---|
| 0011 | 09/24/04<br>ACS | ANSWER (C/S 09/23/04). | |
| 0012 | 10/22/04<br>TRAN | TRANSCRIPT of 9/20/04 rec'd. (Cal Call) | |
| 0013 | 10/22/04<br>TRAN | TRANSCRIPT of 9/21/04 rec'd. (PTRL) | |
| 0014 | 12/03/04<br>BFR | BRIEF for resp. | P 12/03/04 C |
| 0015 | 02/01/05<br>MOTP | MOTION by petr. for leave to file reply brief out of time. (Reply Brf. Ld.) | GR 02/02/05<br>B 02/03/05 C |
| 0016 | 02/02/05<br>RBFP | REPLY BRIEF for petr. | R 02/03/05 |
| 0017 | 03/04/05<br>RBFR | REPLY BRIEF for resp. | P 03/04/05 C |
| 0018 | 03/21/05<br>OSUB | ORDER that case is submitted to Judge Wherry. Case is no longer submitted to S.T. Judge Goldberg. | B 03/21/05 C |
| 0019 | 06/27/05<br>TCOP | T.C. OPINION, Judge Wherry 124 T.C. No. 19. (Decision will be entered for Resp.) | B 06/27/05 C |
| 0020 | 06/27/05<br>DEC | DECISION ENTERED, Judge Wherry | B 06/27/05 C |

| | | | |
|---|---|---|---|
| 0021 | 09/21/05 EA | ENTRY OF APPEARANCE by Carol A. Cantrell. | R 09/21/05 |

APPELLATE PROCEEDINGS

| | | | |
|---|---|---|---|
| 0022 | 09/21/05 NOAP | NOTICE OF APPEAL by petr(s). to U.S.C.A., 2nd Cir. C/S 09/20/05 FEE PAID. C.A.# 05-5151-ag | B 09/22/05 C |
| 0023 | 09/22/05 NOFC | NOTICE of Filing with copy of Not. of App. sent to the parties. | B 09/22/05 C |



**General Docket**
US Court of Appeals for the Second Circuit
• • •

INDIV

CLOSED

Court of Appeals Docket #: 05-5151-ag
Nsuit :

William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue — Filed 9/26/05

Appeal from: Tax Court, Internal Revenue Service

• • •

| | |
|---|---|
| 9/26 | Copy of Tax Court docket entries and notice of appeal on behalf of APPELLANTS William L. Rudkin Testamentary Trust, Michael Knight, filed. [Entry date Sep 28 2005 ] [BM] |
| 9/29/05 | APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, Form C filed, with proof of service. [Entry date Oct 3 2005 ] [BM] |
| 9/29/05 | APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, Form D RECEIVED, with proof of service. [Entry date Oct 4 2005 ] [BM] |
| 9/29/05 | Copy of Tax Court decision dated June 27, 2005, filed. [Entry date Oct 4 2005 ] [BM] |
| 10/12/05 | Notice of appeal acknowledgment letter from Carol Cantrell received. [Entry date Jan 9 2006 ] [BM] |

10/24/05 Telephonic Pre-Argument Notice and Order from Lisa Greenberg, Filed. Scheduled For: Wednesday, November 9, 2005 at 10:0. Oam. [Entry date Oct 28 2005 ] [BM]

10/24/05 Scheduling order #1 filed. Record on appeal due 11/23/2005. Appellants brief due 11/30/2005. Appellees brief due 12/30/2005. Ready week 2/6/2006. (LG) [Entry date Nov 1 2005 ] [BM]

11/3/05 Notice of appearance form on behalf of Anthony Sheehan , Esq., filed. (Orig in acco, copy to Calendar) [Entry date Nov 7 2005 ] [BM]

11/14/05 Scheduling order #2 filed. Record on appeal due 12/23/2005. Appellants brief due 12/30/2005. Appellees brief due 3/1/2006. Ready week 4/10/2006. (LG) [Entry date Nov 21 2005 ] [BM]

11/21/05 Notice to counsel in re: Scheduling order #2 dated 11/14/2005. [Entry date Nov 21 2005 ] [BM]

12/12/05 Record on appeal index in lieu of record filed. [Entry date Jan 13 2006 ] [BM]

12/23/05 Certified copy of the docket entries, copy of the orginal papers and exhibits, and a Docket as of July 05, 2007 8:13 pm Page 5 INDIV CLOSED transcript of the proceedings from APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, received. [Entry date Jan 13 2006 ] [BM]

• • •



1/3/06 APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, brief FILED with proof of service. [Entry date Jan 13 2006 ] [BM]

1/3/06 APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, special appendix filed(w/pfs) [Entry date Jan 13 2006 ] [BM]

1/3/06 APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, joint appendix filed w/pfs. [Entry date Jan 13 2006 ] [BM]

1/6/06 AMICUS CURIAE American Bankers Association, New York Bankers Association, brief filed with proof of service. [Entry date Jan 19 2006 ] [BM]

• • •

3/3/06 APPELLEE Commissioner of Internal Revenue Service, brief filed with proof of service. [Entry date Mar 16 2006 ] [BM]

• • •

3/3/06 Notice of appearance form on behalf of Gilbert Rothenberg , Esq., filed. (Orig in acco, copy to Calendar) [Entry date Mar 20 2006 ] [BM]

3/8/06 Proposed for argument the week of 5/8/06 B PANEL. [Entry date Mar 8 2006 ] [AV]

3/17/06 APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, reply brief filed with proof of service. [Entry date Mar 22 2006 ] [BM]

• • •

3/21/06 Set for argument on 5/10/06 B Panel. [Entry date Mar 21 2006 ] [AV]

• • •

5/10/06 Case heard before FEINBERG, SOTOMAYOR, HALL, C.JJ. CD dated: May 10, 2006 [Entry date May 10 2006 ] [AG]

• • •

10/18/06 Judgment of the tax court is AFFIRMED by published signed opinion filed. (SS) [Entry date Oct 18 2006 ] [BM]

10/18/06 Judgment filed. [Entry date Oct 18 2006 ] [BM]

10/18/06 Notice to counsel in re: Opinion dated 10/18/2006. [Entry date Oct 18 2006 ] [BM]

• • •

11/29/06 APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, petition for rehearing received. [Entry date Nov 30 2006 ] [BM]

12/1/06 Appellant William L. Rudkin Testamentary Trust, Appellant Michael Knight petition for rehearing en banc filed with proof of service. [Entry date Dec 4 2006 ] [BM]

1/19/07 Notice to counsel in re: Order Denying Petition for Rehearing. [Entry date Jan 19 2007 ] [BM]



1/19/07 Order FILED DENYING petition for rehearing en banc by Appellant William L. Rudkin Testamentary Trust, Appellant Michael Knight. (AMH) [Entry date Jan 23 2007 ] [BM]

• • •

2/9/07 Judgment MANDATE ISSUED. CLOSED [Entry date Feb 9 2007 ] [BM]

2/9/07 Notice to counsel in re: Judgment MANDATED on 2/9/2007. [Entry date Feb 9 2007 ] [BM]

3/27/07 Notice of filing petition for APPELLANT William L. Rudkin Testamentary Trust, Michael Knight, dated 3/23/2007 filed. Supreme Court #: 06-1286. [Entry date Apr 2 2007 ] [BM]

7/2/07 Writ of Certiorari GRANTED [Entry date Jul 5 2007 ] [BM]

Docket as of July 05, 2007 8:13 pm

• • •

**STIPULATION OF FACTS**

UNITED STATES TAX COURT

| | | |
|---|---|---|
| WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE, | ) | |
| Petitioner, | ) | Docket No. |
| v. | ) | 3297-04S |
| COMMISSIONER OF INTERNAL REVENUE, | ) | |
| Respondent. | ) | |

**STIPULATION OF FACTS**

The parties agree to this stipulation of facts pursuant to Tax Court Rule 91. All stipulated facts shall be conclusive. All stipulated original exhibits shall be considered authentic. All stipulated copies shall be considered duplicates of the originals as defined in Fed. R. Evid. Sec. 1001(4). The truth of assertions within stipulated exhibits is not necessarily agreed to and may be rebutted or corroborated by additional evidence. Any relevance objection may be made with respect to all or any part of this stipulation at or before the time of trial, but all other evidentiary objections are waived unless specifically expressed in this stipulation.

1. Attached and marked as Exhibit 1-J is a copy of the December 5, 2003 notice of deficiency for the year 2000, on which this case is based.

2. At the time of filing the petition forming the basis of this case, petitioner's address was c/o Michael J. Knight & Co., CPAs, 116 Sherman Street, Fairfield, CT 06824.



3. A copy of the 2000 Form 1041 filed by the petitioner is attached and marked as Exhibit 2-J.

4. A copy of pertinent portions of the Will of Henry A. Rudkin (pages 1, 4-6, 13-17, 27 and 28), under which the subject Trust was established is attached and marked as Exhibit 3-J.

5. During 2000, the petitioner engaged Warfield Associates, Inc. to provide investment management advice for the Trust. Copies of the four quarterly invoices directed to the trust during the year 2000 are grouped, attached and marked as Exhibit 4-J. $22,241 was paid during 2000 to Warfield Associates, Inc.

6. The 2000 Trust tax return (Form 1041) claimed a deduction in the amount of $22,241 for investment management fees paid to Warfield Associates, Inc. on Line 15a - "Other deductions not subject to the 2% floor." The respondent allowed $9,780 of this amount as exceeding 2% of adjusted gross income of $623,050.

DONALD L. KORB
Chief Counsel
Internal Revenue Service

/s/ Michael J. Knight, Trustee
MICHAEL J. KNIGHT
TRUSTEE, WILLIAM L.
RUDKIN TESTAMENTARY
TRUST U/W/0 HENRY A.
RUDKIN Petitioner
c/o Michael J. Knight & Co.,
CPAs 116 Sherman Street
Fairfield, CT 06824
Tel. No. (203) 259-2727

Date: **SEP 21 2004**

By: /s/ Frank W. Louis
FRANK W. LOUIS
Attorney
Tax Court No. LF0138
Commerce Center One
333 East River Drive,
Ste. 200
East Hartford, CT 06108
Tel. No. (860) 290-4083

Date: **SEP 21 2004**

Form 1041 Department of the Treasury - Internal Revenue Service 0824414727117

# U.S. Income Tax Return for Estates and Trusts 2000

For calendar year 2000 or fiscal year beginning , 2000, and ending , OMB No. 1545-0092

A Type of entity:
- [ ] Decedent's estate
- [X] Simple trust
- [ ] Complex trust
- [ ] Grantor type trust
- [ ] Bankruptcy estate-Ch. 7
- [ ] Bankruptcy estate-Ch. 11
- [ ] Pooled income fund

Name of estate or trust (If a grantor type trust, see page 10 of the instructions)
WILLIAM L RUDKIN TESTAMENTARY TRUST
U/W/O HENRY A RUDKIN

Name and title of fiduciary
MICHAEL J. KNIGHT, TRUSTEE

Number, street, and room or suite no. (If a P.O. box, see instructions.)
C/O MICHAEL J KNIGHT & CO 116 SHERMAN ST

City or town, state, and ZIP code
FAIRFIELD, CT 06430

C Employer identification number: 06 6098457

D Date entity created: 04/14/1967

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions)
- [ ] Described in section 4947(a)(1)
- [ ] Not a private foundation
- [ ] Described in section 4947(a)(2)

B Number of Schedules K-1 attached ▶ 1

F Check applicable boxes: [ ] Initial return [ ] Final return [ ] Amended return [ ] Change in fiduciary's name [ ] Change in fiduciary's address

G Pooled mortgage account: [ ] Bought [ ] Sold Date:

| | | | | |
|---|---|---|---|---|
| Income | 1 | Interest income | 1 | |
| | 2 | Ordinary dividends SEE STATEMENT 1 | 2 | 11,594. |
| | 3 | Business income or (loss) (attach Schedule C or C-EZ (Form 1040)) | 3 | |
| | 4 | Capital gain or (loss) (attach Schedule D (Form 1041)) | 4 | 612,954. |
| | 5 | Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040)) | 5 | |
| | 6 | Farm income or (loss) (attach Schedule F (Form 1040)) | 6 | |
| | 7 | Ordinary gain or (loss) (attach Form 4797) | 7 | |
| | 8 | Other income. List type and amount SEE STATEMENT 2 | 8 | 268. |
| | 9 | Total income. Combine lines 1 through 8 ▶ | 9 | 624,816. |
| Deductions | 10 | Interest. Check if Form 4952 is attached ▶ [ ] SEE STATEMENT 3 | 10 | 9,187. |
| | 11 | Taxes | 11 | 22,590. |
| | 12 | Fiduciary fees | 12 | |
| | 13 | Charitable deduction (from Schedule A, line 7) | 13 | |
| | 14 | Attorney, accountant, and return preparer fees SEE STATEMENT 5 | 14 | 11,253. |
| | 15a | Other deductions not subject to the 2% floor (attach schedule) SEE STATEMENT 4 | 15a | 22,241. |
| | b | Allowable miscellaneous itemized deductions subject to the 2% floor | 15b | |
| | 16 | Total. Add lines 10 through 15b | 16 | 65,271. |
| | 17 | Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶ | 17 | 559,545. |
| | 18 | Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041)) | 18 | |
| | 19 | Estate tax deduction (including certain generation-skipping taxes) (attach computation) | 19 | |
| | 20 | Exemption | 20 | 300. |
| | 21 | Total deductions. Add lines 16 through 20 ▶ | 21 | 300. |
| Tax and Payments | 22 | Taxable income. Subtract line 21 from line 17. If a loss, see instructions | 22 | 559,245. |
| | 23 | Total tax (from Schedule G, line 7) | 23 | 116,252. |
| | 24 | Payments: a 2000 estimated tax payments and amount applied from 1999 return | 24a | 85,680. |
| | b | Estimated tax payments allocated to beneficiaries (from Form 1041-T) | 24b | |
| | c | Subtract line 24b from line 24a | 24c | 85,680. |
| | d | Tax paid with extension of time to file: [ ] Form 2758 [ ] Form 8736 [ ] Form 8800 | 24d | |
| | e | Federal income tax withheld. If any is from Form(s) 1099, check ▶ [ ] | 24e | |
| | | Other payments: f Form 2439 ; g Form 4136 ; h Total ▶ | 24h | |
| | 25 | Total payments. Add lines 24c through 24e, and 24h ▶ | 25 | 85,680. |
| | 26 | Estimated tax penalty (see page 16 of the instructions) | 26 | |
| | 27 | Tax due. If line 25 is smaller than the total of lines 23 and 26, enter amount owed | 27 | 30,572. |
| | 28 | Overpayment. If line 25 is larger than the total of lines 23 and 26, enter amount overpaid | 28 | |
| | 29 | Amount of line 28 to be: a Credited to 2001 estimated tax ▶ b Refunded ▶ | 29 | |

SELECTED

ANDOVER IRS CENTER RECEIVED APR 02 2001 MAIL 310 GROVE ST. - ANDOVER, MA 01812

Sign Here: Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than fiduciary) is based on all information of which preparer has any knowledge.

Michael J Knight CPA 3/22/01 ▶
Signature of fiduciary or officer representing fiduciary — Date — EIN of fiduciary if a financial institution (see page 9 of the instructions)

Paid Preparer's Use Only

Preparer's signature: CPA — Date: 3/22/01 — Check if self-employed ▶ [X] — Preparer's SSN or PTIN: P00182555

Firm's name (or yours if self-employed), address, and ZIP code: MICHAEL J. KNIGHT & COMPANY, CPAS, 116 SHERMAN STREET, FAIRFIELD, CONNECTICUT 06430 — EIN ▶ 06 1156122 — Phone no. (203)259-2727

For Paperwork Reduction Act Notice, see the separate instructions. Form 1041 (2000)

JWA 0H8801 12-12-00



EXHIBIT 2-J

12
Excerpt from Exhibit 2-J
[to Stipulation of Facts]

**Excerpt from Exhibit 2-J [to Stipulation of Facts]**
**(Cont'd)**

06-6098457
WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W

* * *

FORM 1041 OTHER DEDUCTIONS NOT SUBJECT TO FLOOR LIMITATION STATEMENT 4

| DESCRIPTION | DIRECT AMOUNT | INDIRECT AMOUNT |
|---|---|---|
| INVESTMENT MANAGEMENT FEES | 22,241. | |
| TOTAL TO FORM 1041, LINE 15A | | 22,241. |

* * *

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 1-4 of 9; Columns 5-9 can be found on p. 19, *infra*]**

January 11, 2001

WARFIELD ASSOCIATES, INC.
Realized Gains and Losses
From 01/01/2000 to 12/31/2000

HENRY RUDKIN TR FIB WILLIAM Acct # W512

Realized Gains and Losses

| Description | Acquired | Date Sold | Quantity |
|---|---|---|---|
| VITESSE SEMICONDUCTOR | 04/21/1998 | 01/25/2000 | 2,000.000 |
| VITESSE SEMICONDUCTOR | 10/23/1998 | 01/25/2000 | 500.000 |
| | | | 2,500.000 |
| WORLDCOM INC GA | 03/25/1998 | 02/03/2000 | 1,200.000 |



**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 1-4 of 9; Columns 5-9 can be found on p. 20, *infra*]**

| Description | Acquired | Date Sold | Quantity |
|---|---|---|---|
| WORLDCOM INC GA | 06/17/1998 | 02/03/2000 | 350.000 |
| | | | 1,550.000 |
| DELL COMPUTER CORP | 09/03/1997 | 04/27/2000 | 2,000.000 |
| GUIDANT CORP | 04/14/1998 | 04/27/2000 | 800.000 |
| VITESSE SEMICONDUCTOR | 10/23/1998 | 04/27/2000 | 1,000.000 |
| WORLDCOM INC GA | 06/17/1998 | 04/27/2000 | 250.000 |
| WORLDCOM INC GA | 11/09/1998 | 04/2712000 | 750.000 |
| | | | 1,000.000 |
| CISCO SYSTEMS | 12/05/1995 | 05/09/2000 | 1,800.000 |

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 1-4 of 9; Columns 5-9 can be found on p. 21, *infra*]**

| Description | Acquired | Date Sold | Quantity |
|---|---|---|---|
| DELL COMPUTER CORP | 09/03/1997 | 05/09/2000 | 825.000 |
| VITESSE SEMICONDUCTOR | 10/23/1998 | 05/09/2000 | 1,000.000 |
| LUCENT TECHNOLOGIES | 01/07/1998 | 07/27/2000 | 1,000.000 |
| LUCENT TECHNOLOGIES | 01/07/1998 | 08/15/2000 | 1,000.000 |
| DELL COMPUTER CORP | 09/03/1997 | 08/23/2000 | 500.000 |
| DELL COMPUTER CORP | 12/03/1997 | 08/23/2000 | 2,000.000 |
| | | | 2,500,000 |
| CITIGROUP INC. | 04/19/1993 | 09/08/2000 | |
| VITESSE SEMICONDUCTOR | 10/23/1998 | 09/11/2000 | 500.000 |

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**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 1-4 of 9; Columns 5-9 can be found on p. 22, *infra*]**

| Description | Acquired | Date Sold | Quantity |
|---|---|---|---|
| VITESSE SEMICONDUCTOR | 10/29/1998 | 09/12/2000 | 1,000.000 |
| LUCENT TECHNOLOGIES | 01/07/1998 | 09/2112000 | 2,000.000 |
| JDS UNIPHASE | 07/27/2000 | 11101/2000 | 250.000 |
| BROADCOM | 11/01/2000 | 11/10/2000 | 150.000 |
| SUN MICROSYSTEMS | 09/21/2000 | 12/0112000 | 800.000 |
| Total Short Term (Sales) | | | |
| Total Long Term (Sales) | | | |

17

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 1-4 of 9; Columns 5-9 can be found on p. 23, *infra*]**

| Description | Acquired | Date Sold | Quantity |
|---|---|---|---|
| Total (Sales) | | | |
| Total Gains | | | |



**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 5-9 of 9; Columns 1-4 can be found on p. 14, *supra*]**

January 11, 2001

WARFIELD ASSOCIATES, INC.
Realized Gains and Losses
From 01/01/2000 to 12/31/2000

HENRY RUDKIN TR FIB WILLIAM Acct # W512

Realized Gains and Losses

| Net Proceeds | Cost | Short Term Gains | Long Term Gains | Total Gains |
|---|---|---|---|---|
| 98,636.64 | 28,614.85 | | 70,021.79 | 70,021.79 |
| 24,659.16 | 7,618.27 | | 17,040.89 | 17,040.89 |
| 123,295.80 | 36,233.12 | | 87,062.68 | 87,062.68 |
| 52,996.30 | | | | |

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 5-9 of 9; Columns 1-4 can be found on p. 15, *supra*]**

| Net Proceeds | Cost | Short Term Gains | Long Term Gains | Total Gains |
|---|---|---|---|---|
| 15,457.26 | *39014* | | *29440* | *29440* |
| 68,453.56 | | | | |
| 101,683.75 | 21,364.54 | | 80,319.21 | 80,319.21 |
| 44,471.36 | 30,330.78 | | 14,140.58 | 14,140.58 |
| 59,015.32 | 15,236.53 | | 43,778.79 | 43,778.79 |
| 10,986.49 | 7,506.53 | | 3,479.96 | 3,479.96 |
| 32,959.45 | 28,583.36 | | 4,376.09 | 4,376.09 |
| 43,945.94 | 36,089.89 | | 7,856.05 | 7,856.05 |
| 109,429.58 | 8,622.81 | | 100,806.77 | 100,806.77 |



**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 5-9 of 9; Columns 1-4 can be found on p. 16, *supra*]**

| Net Proceeds | Cost | Short Term Gains | Long Term Gains | Total Gains |
|---|---|---|---|---|
| 37,762.19 | 8,812.87 | | 28,949.32 | 28,949.32 |
| 55,095.51 | 15,236.53 | | 39,858.98 | 39,858.98 |
| 47,780.23 | 20,479.40 | | 27,300.83 | 27,300.83 |
| 41,054.84 | 20,479.40 | | 20,575.44 | 20,575.44 |
| 18,623.93 | 5,341.14 | | 13,282.79 | 13,282.79 |
| 74,495.74 | 22,222.11 | | 52,273.03 | 52,273.03 |
| 93.119.67 | 27,563,85 | | 65,555 82 | 65.555.82 |
| | 2.08 | | 16.36 | 16.36 |
| 41,531.67 | 7,618.27 | | 33,913.40 | 33,913.40 |

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 5-9 of 9; Columns 1-4 can be found on p. 17, *supra*]**

| Net Proceeds | Cost | Short Term Gains | Long Term Gains | Total Gains |
|---|---|---|---|---|
| 80,48314 | 16,404.04 | | 64,079.70 | 64,079.70 |
| 66,488.74 | 40,958,81 | | 25,529 | 25,529.93 |
| 19,620. | 33,674.13 | | | |
| 23,828. | 32,927.06 | | | -9,098.67 |
| 60,767. | 93,844.39 | | | |

22

**Excerpt from Exhibit 2-J [to Stipulation of Facts] (Cont'd)**
**[Columns 5-9 of 9; Columns 1-4 can be found on p. 18, *supra*]**

| Net Proceeds | Cost | Short Term Gains | Long Term Gains | Total Gains |
|---|---|---|---|---|
| 1,117,846.49 | *504,892* | | *669,182* | *612,954* |

23

**Exhibit 4-J [to Stipulation of Facts]**

**WARFIELD ASSOCIATES, INC.** *HAR*
450 PARK AVENUE, SUITE 1401 *WLR*
NEW YORK, NY 10022
(212) 319-6755 • Fax (212) 319-6840

January 14, 2000

Michael J. Knight & Company
116 Sherman Street
P. O. Box 139
Fairfield, CT 06430-0139

Att: John Rolleri

Re: [redacted] Rudkin Trusts

Investment management fee for the quarter beginning January 1, 2000, based on portfolios valued below at an annual rate of 0.80%

*Paid # 960*
*1/19/2000*

William U/W/O Henry $2,884,542.00 $5,769.08

0•
5·769·08+
6·855·42+
5·164·37+
4·452·44+
004
22·241·31•

Please remit to Warfield Associates, Inc.

EXHIBIT 4 -J



**WARFIELD ASSOCIATES, INC.**
450 PARK AVENUE, SUITE 1401
NEW YORK, NY 10022
(212) 319-6755 • Fax (212) 319-6840

April 12, 2000

Michael J. Knight & Company
116 Sherman Street
P. O. Box 139
Fairfield, CT 06430-0139

Att: John Rolleri

Re: [redacted] Rudkin Trusts

Investment management fee for the quarter beginning April 1, 2000, based on portfolios valued below at an annual rate of 0.80%

William U/W/O Henry $3,427,708.00 $6,855.42

*719*
*Paid # 984*
*5/1/2000*

Please remit to Warfield Associates, Inc.

**WARFIELD ASSOCIATES, INC.**
450 PARK AVENUE, SUITE 1401
NEW YORK, NY 10022
(212) 319-6755 • Fax (212) 319-6840

*719*

July 11, 2000

Michael J. Knight & Company
116 Sherman Street
P. O. Box 139
Fairfield, CT 06430-0139

Att: John Rolleri

Re: [redacted] Rudkin Trusts

Investment management fee for the quarter beginning June 30, 2000, based on portfolios valued below at an annual rate of 0.80%

| | | |
|---|---|---|
| William U/W/O Henry | $2,582,186.00 | $5,164.37 |

*Paid # 1001*
*7/20/2000*

Please remit to Warfield Associates, Inc.



**WARFIELD ASSOCIATES, INC.**
450 PARK AVENUE, SUITE 1401
NEW YORK, NY 10022
(212) 319-6755 • Fax (212) 319-6840

*719*

October 11, 2000

Michael J. Knight & Company
116 Sherman Street
P. O. Box 139
Fairfield, CT 06430-0139

Att: John Rolleri

Re: [redacted] Rudkin Trusts

Investment management fee for the quarter beginning September 30, 2000, based on portfolios valued below at an annual rate of 0.80%

| | | |
|---|---|---|
| William U/W/O Henry | $2,226,222.00 | $4,452.44 |

*Paid # 1016*
*10/18/2000*

Please remit to Warfield Associates, Inc.

FILED
AUG 2 3 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 06-1286

IN THE

# Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent*.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

## BRIEF FOR PETITIONER

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Washington, DC 20006
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*Counsel for Petitioner*

AUGUST 23, 2007

## QUESTION PRESENTED

Whether costs for trust and estate investment management and advisory services incurred in order to fulfill a trustee's unique fiduciary obligation with respect to investment of the assets of a trust or estate are fully deductible from trust or estate income under 26 U.S.C. § 67(e) as costs "which would not have been incurred if the property were not held in such trust or estate."

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## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit (Petition Appendix ("Pet. App.") 1a-19a) is published at 467 F.3d 149. The decision of the Tax Court (Pet. App. 20a-30a) is published at 124 T.C. 304.

## JURISDICTION

The judgment of the Court of Appeals was entered on October 18, 2006. Pet. App. 1a. A timely Petition for Rehearing was denied on January 19, 2007. Pet. App. 31a-32a. The Petition for Writ of Certiorari was filed on March 23, 2007, and granted by this Court on June 25, 2007. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

## RELEVANT STATUTORY PROVISION

Section 67(e) of the Internal Revenue Code, 26 U.S.C. § 67(e), provides in relevant part:

> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—
>
> > (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate. . .
>
> shall be treated as allowable in arriving at adjusted gross income.

The full text of 26 U.S.C. § 67 as amended is set out in Appendix A, Appendix ("Pet. Br. App.") 1a. The full text of 26 U.S.C. § 67 (1986) as originally adopted in the Tax Reform Act of 1986 is set out in Appendix B, id. 5a.

## INTRODUCTION

This case concerns whether expenses paid by the trustees of a nongrantor trust or estate for professional investment management are deductible in full from the trust's or estate's

income for trust or estate income tax purposes.[1] Our position is that under the clear congressional language of 26 U.S.C. § 67(e), such "investment advice" fees are fully deductible.

The Internal Revenue Code (the "Revenue Code" or the "Code") has long treated "the trust as an entity for producing income comparable to a business enterprise . . . and permits deductions of management expenses of the trust. . ." *Bingham's Trust v. Commissioner*, 325 U.S. 365, 374 (1945). More than thirty years ago, Congress made clear that "costs paid or incurred in connection with the administration of the estate or trust" were deductible from trust or estate income – much as they are from the income of taxable corporations – even when similar fees were not fully deductible from individual income. 26 U.S.C. § 57(b)(2)(B)(i) (1977).

In the Tax Reform Act of 1986 (the "1986 Act" or the "Act"), Congress added a second clause to this statutory language. The relevant provision, codified at 26 U.S.C. § 67(e)(1), now permits the deduction in full of "costs which are paid or incurred in connection with the administration of the estate or trust *and which would not have been incurred if the property were not held in such trust or estate.*" Id. (emphasis added). If trust and estate investment advice fees are such costs, they may be deducted in full from trust or estate

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[1] The statutory provision involved in the question here, 26 U.S.C. § 67(e), applies only to nongrantor trusts, and only such trusts are at issue in this case. So-called grantor trusts are generally trusts in which the grantor retains certain powers or interests. See, *e.g.*, 26 U.S.C. § 674(a) (grantor trust created where grantor retains the authority to determine who will receive the income or corpus of the trust). They are often utilized for estate planning purposes, but are deemed to have no independent income tax significance and are disregarded and treated as mere conduits for income tax purposes. All their income is taxed to their grantor every year. Cf. *Helvering v. Clifford*, 309 U.S. 331, 335 (1940) (where grantor retains "dominion and control" over property, he or she remains its owner); *Corliss v. Bowers*, 281 U.S. 376, 371 (1930) (Holmes, J.) ("taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed"). Generic references to "trusts" throughout this brief refer only to nongrantor trusts.

income for trust or estate income tax purposes. If not, they are subject to a limitation on deductibility, as similar expenses are under the 1986 Act when incurred by individuals, a limitation that would result in the reduction of trust corpus not just once, but year after year. Trust and estate investment advice fees are perhaps the largest single cost involved in the administration of most trusts and estates. The question before the Court is therefore one of great significance, particularly for the beneficiaries that trusts and estates are created and designed to protect.

Respondent Commissioner of Internal Revenue (the "Commissioner") argues that trust and estate investment advice fees are no longer deductible in full. But there is no indication in the text, structure or history of § 67, the 1986 Act, or the Code more broadly, that Congress had a purpose to work such a significant change in the way trusts and estates are taxed. Rather, as its text makes clear, Congress sought to ensure full deductibility in § 67 for all costs incurred in the administration of a trust or estate that are caused by the fact that the property is held in that trust or estate.

Trust investment advice fees meet that test.[2] Such fees are different in kind from similar fees incurred by individuals. Trust investment advisors must always take into account the unique fiduciary obligation of the trustee to invest the trust or estate assets for the benefit of all the beneficiaries in light of the purposes, terms, distribution requirements and other circumstances of the particular trust or estate. This may include among other things balancing competing interests of differently situated beneficiaries. Fees incurred for such advice are therefore always incurred because assets are in the trust – the particular type of advice would not have been needed, and the corresponding fee would not have been incurred, "if the property were not held in such trust or es-

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[2] While the statute is applicable to trusts and estates, this case involves a trust. References to "trusts" throughout this brief are intended to encompass both trusts and estates unless context indicates otherwise.

tate." These fees are, therefore, fully deductible under the statute. This interpretation of § 67(e) is confirmed by the structure, history and purposes of § 67 and the Internal Revenue Code more broadly. It is, indeed, the only plausible reading of the statutory text.

## STATEMENT

**1.** The William L. Rudkin Testamentary Trust ("Trust" or "Rudkin Trust") was established in 1967 under the will of Henry A. Rudkin, Sr. ("Rudkin" or "Henry Rudkin"). Rudkin, with his wife Margaret, founded Pepperidge Farm, maker of cookies and other food products. The Trust was funded with some of the proceeds of the 1961 sale of Pepperidge Farm to the Campbell Soup Company.

The Will and its First Codicil (the "Trust Documents") require all the trust income to be paid out each year for the benefit of a class of income beneficiaries. Pet. App. 35a.[3] Upon its expiration, "the principal of the trust" will be distributed to certain living descendants of Henry Rudkin (the remainder beneficiary class). Pet. App. 36a.

The Trust is designed to last for generations. The Trust expires twenty-one years after the death of the last survivor of Henry Rudkin's descendants living at the time of his death (or, if it occurs earlier, upon the deaths of William L. Rudkin and all of his descendants). Pet. App. 36a. The youngest of Rudkin's descendants who were living at the time of his death, Katharine Rudkin Allsopp, is now 49 years old. If she

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[3] The Trustees of the Trust ("Trustees") must pay or apply "so much of the net income of the trust as [they] deem necessary or desirable in their discretion for the support, comfort and education" of any or all members of an income beneficiary class comprising Rudkin's son William L. Rudkin, his wife or widow, and his descendants and their spouses, "in accordance with [the Trustees'] understanding of the individual and varying needs and resources from time to time of the members of such class." Pet. App. 35a. Any remaining Trust income must be placed into separate trusts for the individual members of that income beneficiary class. Id.

lives to be eighty, the Trust will not expire until 2059.[4]

**2.** Unlike individuals who often invest their own funds, putting their assets into a range of mutual funds or other standard investment vehicles without hiring investment advisors, a trustee who is not an experienced investor is under an affirmative fiduciary duty to delegate his or her investment functions to a qualified and competent agent. See Restatement (Third) of Trusts: Prudent Investor Rule ("Restatement 3d") § 171 cmts. a, f-h, at 140-41, 143-45, and § 227 cmt. j, at 38-41 (1992). A trustee's failure to obtain competent investment assistance when such assistance is necessary subjects the trustee to the risk of substantial personal liability to the beneficiaries.[5]

Because of their fiduciary obligations, many trustees utilize the services of professionals to provide trust investment management and advisory services. Internal Revenue Service ("IRS") statistics indicate that fees for this purpose may be the single largest expense connected with the administration of trusts and estates, with several billion dollars in fees

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[4] The Trust Documents specify that during the pendency of the Trust, the Trustees retain discretion to distribute principal should they deem it "necessary or desirable" either "for the education, support, comfort or welfare" of one or more members of the income beneficiary class, or "to advance the best interests of such member or members [of that class] in any business venture in which such member or members may be engaged or in which such members may wish to engage." Pet. App. 45a-46a. The Trustees are also required to distribute portions of the trust principal to any persons or organizations designated by Rudkin's son William during his life or in his will if it was duly admitted to probate (except for William Rudkin himself or his estate or their creditors). Pet. App. 36a. At the beginning of the tax year at issue in this case, 2000, the Trust had assets worth $2,884,542; at the beginning of the final quarter of that year, it had assets worth $2,226,222. Joint Appendix ("J.A.") 24, 27.

[5] See generally Restatement 3d §§ 205, 208-211, Reporter's Notes, at 166-173 and cases cited therein (describing the trustee's liability for both actual losses and failure to realize the gains that would have been realized if the trust assets had been invested properly).

paid each year for such services.[6]

**3.** The Trustees of the Rudkin Trust ("Trustees") have unique fiduciary obligations in their management of the Trust assets:

The Trustees are subject to the Connecticut Uniform Prudent Investor Act ("UPIA"). Conn. Gen. Stat. §§ 45a-541a to 45a-541*l*. That statute utilizes the "prudent investor" standard which requires trustees to invest and manage trust assets "by considering the purposes, terms, distribution requirements and other circumstances of the trust," id. § 45a-541b(a), and to evaluate "investment and management decisions respecting individual assets . . . not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Id. § 45a-541b(b). The statute requires the Trustees to consider ten enumerated circumstances in investing and managing Trust assets, including "the nature and estimated duration of the trust." Id. § 45a-541b(c). Conn. Gen. Stat. §45a-541b(c) provides in full:

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[6] See Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 5 (IRS 2007) (Fiduciary Income Tax Returns, Income, Deductions, and Tax Liability, by Tax Status, and Size of Gross Income, Filing Year 2005) available at http://www.irs.gov/pub/irs-soi/05fd01.xls. The IRS does not publish data that precisely disaggregate these costs. For the most recently reported year, IRS data show a total of $5.6 billion in deductions on fiduciary income tax returns for a category known as "other deductions not subject to the two-percent floor." Id. at col. 32 & n.1. The largest component of that category was likely deductions for fees for trust and estate investment advisory and management services like the deduction taken here. The data also show a total of $1.5 billion for what are called "allowable miscellaneous deductions." Id. at col. 34. Under rulings of the Fourth and Federal Circuits described below, some trusts and estates categorized their fees for investment advice in that category, and, again, such fees were likely the largest single type of deduction within that category. Finally, the data show $4.0 billion deducted in that one year for trustees' and other fiduciaries' fees. Id. at col. 26. These fees, too, are primarily for investment advice and management. To the extent it is relevant to this case, these categories will be described more fully below.

> Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) General economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions, strategies and distributions; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property and real property; (5) the expected total return from income and the appreciation of capital; (6) related trusts and other income and resources of the beneficiaries; (7) needs for liquidity, for regularity of income and for preservation or appreciation of capital; (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries; (9) the size of the portfolio; and (10) the nature and estimated duration of the trust.

The State of Connecticut monitors the Trustees' compliance with their obligations. The Connecticut Probate Court has appointed a guardian *ad litem* to protect the interests of the unborn beneficiaries of the Trust. See *Estate of Henry A. Rudkin*, Order of the Probate Court for the District of Fairfield, Fairfield Probate Court Records, Vol. 288, p. 644 (December 21, 1970). The Trustees are required to file a detailed principal and income trust accounting with the guardian and the Probate Court every three years. See Conn. Gen. Stat. § 45a-177.

**3.** The "prudent investor" standard has been adopted in all 50 States and the District of Columbia.[7] That standard

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[7] Versions of the Uniform Prudent Investor Act have been adopted by 44 States and the District of Columbia. See Uniform Law Commission, A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Aug. 17, 2007) (listing States). Five of the remaining States have adopted versions of the prudent investor standard. See Del. Code. Ann.

does not allow the Trustees to invest the Trust assets as individuals would, or do, invest their own assets. Thus, for instance, an inexperienced investor, or one not wishing to devote time to learning about different investment alternatives and monitoring their status on an ongoing basis, may reasonably decide to invest his or her own funds solely in "safe" investments such as Treasury obligations, high-quality tax-exempt municipal bonds, or federally-insured savings accounts. If he or she were a trustee, however, that same course of decision would likely breach the fiduciary duty.[8] Similarly, an individual may reasonably decide to concentrate his or her personal investments in a single class of stocks or securities because he or she is particularly knowledgeable about or impressed by investments in that area. He or she may not do so as trustee, however, even if he or she is

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tit. 12, § 3302 (2007); Fla. Stat. § 518.11 (2007); Ga. Code Ann. § 53-12-287 (2007); La. Rev. Stat. Ann. § 9:2127 (2007); N.Y. Est. Powers & Trusts Law § 11-2.3 (2007). In Kentucky, the prudent investor standard is applicable only in certain circumstances. Ky. Rev. Stat. Ann. §§ 286.3-277, 386.454(1), 386.502 (2006).

The universal adoption of the prudent investor standard marks the rejection of the traditional "prudent person" rule, see *Harvard College v. Amory*, 26 Mass. 446, 469 (1830), as a description of fiduciary obligation. The prudent person standard had been criticized by "scholars and practitioners familiar with modern portfolio theory." See Schanzenbach and Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J. L & Econ. (forthcoming 2007) (manuscript at 5-9, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=868761). "Assessing the prudence of a particular investment . . . requires consideration of the portfolio as a whole, the beneficiary's tolerance of risk, and the purpose of the trust. . . . [Investments] favored under the old prudent [person] rule[] expose[d] the trust fund to considerable inflation risk." Id. at 8.

[8] See Restatement 3d § 227 cmt. e, illus. 11, at 22 (not "prudent" to invest solely in short-term bank and federal obligations); *Baker Boyer Nat'l Bank v. Garver*, 719 P.2d 583 (Wash. Ct. App.), review denied, 106 Wash. 2d 1017 (1986) (not "prudent" to invest solely in tax exempt securities); *Hurst v. Security-First Nat'l Bank (In re Bouffleur's Estate)*, 26 Cal. Rptr. 173 (Cal. Ct. App. 1962) (not "prudent" to invest solely in building and loan savings accounts not exceeding $10,000).

seeking the same financial result, and even if he or she has "made his [or her] own fortune" from such investments.[9]

Nor may the fact that the trust property is not diversified when originally placed in the trust, or that the particular trust instrument permits investments otherwise generally considered inappropriate for trusts, relieve the trustee of his or her duty to prudently diversify the trust investments.[10] Likewise, the inclusion of an investment or type of investment in a statutory "legal list" of investments permitted to fiduciaries does not relieve the fiduciary of the duty to invest prudently, including on a diversified basis, in such permitted investments.[11]

Further, an otherwise "prudent" investment may become imprudent in light of changing circumstances, including the nature and mix of other investments in the trust's portfolio, the availability of other possible investments, and the safety, stability and profitability of the instrument, entity or industry in which the trust has invested. Thus, while an individual is free to leave investments largely unattended over time, the trustee's fiduciary duty requires ongoing monitoring and analysis of the trust's investments and the investment market generally in order to ensure that the trust portfolio retains a properly diversified balance of expected risks and returns to provide for the interests of the various beneficiaries.[12]

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[9] See Restatement 3d § 227 cmt. e, illus. 12, at 23; *Buder v. Sartore*, 774 P.2d 1383, 1386 (Colo. 1989) (under the "prudent investor" rule, "[t]he trustee may not subject his trust property to hazards which a man dealing with his own property might consider warranted if to do so would create danger to the trust estate").

[10] Restatement 3d § 228 cmt. f, at 106 ("[T]he fact that an investment is permitted does not relieve the trustee of the fundamental duty to act with prudence. The fiduciary must still exercise care, skill and caution in making decisions to acquire or retain the investment.").

[11] See Restatement 3d § 228 cmt. c, at 102-103.

[12] See Restatement (Second) of Trusts § 231 cmt. b, at 551 (1959); Restatement 3d § 227 cmt. d, at 14 and cmt. e, at 20; Bogert, *The Law of Trusts and Trustees*, § 612 at 20 (3d ed. 2000).

Trustees, unlike individuals, must also ordinarily invest in a way that balances the interests of the various beneficiaries and that takes account of other parameters like the duration of the trust and its purposes.[13] Trustees owe a duty not merely to the trust's remainder beneficiaries to grow the principal through appreciation, but to the current, future and contingent income beneficiaries as well to earn income required to serve the trust's purposes. That dual duty is one of the strongest known in the law. As then-Chief Judge Cardozo said in the classic explication of the fiduciary duty under the common law, and as this Court is well aware:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

*Meinhard* v. *Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.).

**4.** Trusts and estates, like individuals and certain other entities, must pay a tax upon their "taxable income." See 26 U.S.C. § 1(e). Trusts and estates with income above a certain level must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, called a fiduciary income tax return.

Taxable income for both individuals and trusts is derived, first, by taking "gross income," defined as "all income from whatever source derived," 26 U.S.C. § 61(a), and deducting in full certain expenses that are enumerated by statute (called "above-the-line" deductions) in order to arrive at a figure for "adjusted gross income" ("AGI"). See 26 U.S.C. § 62(a). Taxable income is calculated by subtracting from AGI other deductions that are also enumerated by statute. These are

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[13] See Restatement 3d § 227 cmt. i, at 32-38.

called "itemized" or "below-the-line" deductions. See 26 U.S.C. § 67(b) and Code sections cited therein.

Since the adoption of the Tax Reform Act of 1986, a subset of these itemized deductions, called "miscellaneous itemized deductions," has been deductible by individuals only to the extent that these deductions' aggregate "exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a).[14] These miscellaneous itemized deductions are, in other words, no longer fully deductible; the 1986 Act imposed a threshold, referred to among tax specialists as the "two-percent floor," on their deductibility. Congress limited the deductibility of these miscellaneous itemized deductions to prevent taxpayers from deducting expenses with "characteristics of voluntary personal expenditures," S. Rep. 99-313 at 78 (1986), that lacked "a sufficient business or investment purpose." Id. at 78 n.18; H.R. Rep. 99-426 at 109 n.8 (1985). Many expenses are, of course, deductible in our net-income-based system of taxation because "they may constitute costs of earning income." H.R. Rep. 99-426 at 110. But Congress was concerned that individuals were erroneously claiming deductions for things like home office expenses, magazine subscriptions and safe deposit services, and deducting items with "personal" aspects that "would have been incurred apart from any business or investment activities of the taxpayer." S. Rep. 99-313 at 78-79 & n.18; H.R. Rep. 99-426 at 109 n.8. Congress was also concerned about the recordkeeping and auditing burdens for both individuals and the IRS involved in assuring that these deductions were not taken erroneously. See S. Rep. 99-313 78-79 & n.18 (1986); H.R. Rep. 99-426 109-110 & n.8 (1985). The two-percent floor is a rough way of eliminating the personal component from an individual's deductions without the IRS having to make detailed, fact-intensive inquiries unwarranted by the sums in-

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[14] These "miscellaneous itemized deductions" include those itemized deductions not listed in 26 U.S.C. § 67(b). There are over fifty such miscellaneous itemized deductions listed throughout the Code.

volved in each case.

The Code permits both individuals and trusts and estates an itemized deduction for investment management and advisory fees.[15] Individuals, however, may not ordinarily deduct investment management and advisory fees in full in calculating their taxable income. Rather, under Treasury Regulations such fees are treated as "miscellaneous itemized deductions" that are subject to the two-percent floor. See 26 CFR 1.67-1T(a)(1)(ii) (1988).

The Internal Revenue Code, however, has long recognized that the tax treatment of expenses of trusts and estates does not present the same concerns as the tax treatment of expenses of individuals. Thus, for example, in the pre-existing law in place at the time the 1986 Act was passed, all "costs incurred in connection with the administration of trusts and estates," including investment advice fees, were deductible by trusts and estates in arriving at AGI. 26 U.S.C. § 57(b)(2) (1977). That is, these costs were given an "above-the-line" deduction though similar costs incurred by individuals were not. Below-the-line deductions are not allowable in calculating something called the Alternative Mimimum Tax (AMT), which becomes payable when one's income tax would otherwise fall below a level set by statute. Above-the-line deductions are. This provision of law therefore meant that these costs were deductible for trusts and estates required to pay AMT, but that similar ones were not deductible by individuals required to do the same.

In the 1986 Act, in the same section of the Code where it imposed the two-percent floor, Congress, consistent with this prior approach, thus provided a special rule for trusts and estates for the tax treatment of certain costs. The 1986 Act provided, in language codified at 26 U.S.C. § 67(e), that:

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[15] See 26 U.S.C. § 212(2) ("In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred . . . for the management, conservation, or maintenance of property held for the production of income. . . "); 26 CFR 1.212-1(g).

> the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate shall be treated as allowable in arriving at adjusted gross income.

Pub. L. No. 99-514, § 132(a), 100 Stat. 2085, 2114-15 (1986), Pet. Br. App. 6a-7a.

Section 67(e) thus creates an exception to the two-percent floor for certain deductions of trusts and estates. To come within that exception, a cost must fall within each of the two clauses, or prongs, of the statute: First, it must be a "cost[] which [is] paid or incurred in connection with the administration of the estate or trust"; and second, it must be one "which would not have been incurred if the property were not held in such trust or estate." (The fact that § 67(e) treats these costs as deductible in calculating AGI, that is, as "above the line" deductions, means that they will reduce not only ordinary income tax, but the AMT where it is applicable. It is thus also the successor provision to the former § 57(b)(2) described above.)

**5.** The Trustees here themselves lack the skills and training necessary to make the investment decisions required by their fiduciary obligations. In order to comply with these obligations, the Trustees therefore engaged Warfield Associates, Inc., ("Warfield"), an SEC registered investment advisor in New York, to manage the Trust assets.[16] Warfield charged the Trust an annual fee of 0.8% of Trust assets, billed quarterly. During 2000, the tax year at issue here,

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[16] The Trust Documents provide that the Trustees may "employ such agents, experts and counsel as they may deem advisable in connection with the administration and management" of the Trust. Pet. App. 41a. This delegation is expressly permitted by the Connecticut statute, see Conn. Gen. Stat. § 45a-541i(a).

Warfield charged, and the Trustees paid, quarterly fees totaling $22,241.31 for Warfield's services. J.A. 24-27. In calculating the Trust's taxable income on the Trust's Form 1041, the Trustees included a deduction for the full amount of Warfield's fees because they were costs incurred in connection with the Trust's administration that "would not have been incurred if the property were not held" in the Rudkin Trust. J.A. 12 (line 15a), 13.

Respondent, the Commissioner of Internal Revenue ("the Commissioner"), disallowed this full deduction, permitting the Trust to deduct these fees only to the extent that they exceeded two percent of the Trust's adjusted gross income.[17] The parties agree that fees paid for investment management and advisory services are "costs which are paid or incurred in connection with the administration of the estate or trust" within the meaning of the first prong of § 67(e).[18] In the Commissioner's view, however, these fees failed to meet the statute's second prong. He issued a Notice of Deficiency to the Trust in the amount of $4,448.[19]

Petitioner Trustee Michael J. Knight petitioned the Tax Court for a redetermination of deficiency. See 26 U.S.C. §§ 6212, 6213, 6214 and 7442. The Tax Court sustained the Commissioner's position in reliance on its previous decision in *O'Neill v. Commissioner*, 98 T.C. 227 (1992), rev'd 994 F.2d 302 (CA6 1993). The Sixth Circuit in fact reversed in *O'Neill*, holding that "certain expenditures *unique* to trust administration are excepted from the two percent floor" by §

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[17] The Trust had no other miscellaneous itemized deductions subject to the two-percent floor that could have been aggregated with these costs. See J.A. 12.

[18] See Pet. App. 6a; *Ungermann Trust v. Commissioner*, 89 T.C. 1131 (1983) (a very broad range of costs are included within the universe of costs covered by this statutory language).

[19] The parties subsequently discovered and agree that there was an error of approximately $11,000 in the calculation of adjusted gross income in the Trust's return. The amount of the alleged deficiency, though, was ultimately not altered by this correction. See Pet. App. 3a.

67(e), 994 F.3d at 303 (emphasis in original). The court of appeals there concluded that the trust investment advice fees at issue were among them because "the investment advisor fees paid by the Trust were costs incurred because the property was held in trust." Id. at 304. As the court explained, the costs were "caused by the fiduciary duties of the co-trustees. . . . [F]iduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." Id.

The Tax Court, however, chose to follow the decisions of the Federal Circuit in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (CAFed 2001), and the Fourth Circuit in *Scott v. United States*, 328 F.3d 132 (CA4 2003).[20] In those cases, those two courts of appeals concluded that only costs of a type not "customarily" or "commonly" incurred by individuals were fully deductible by trusts and estates. 265 F.3d at 1281 (costs that "that are unique to the administration of a trust and not customarily incurred outside of trusts"); 328 F.3d at 139-140 (quoting this language then equating it with a rule that "expenses commonly incurred by individual taxpayers" are not fully deductible). The Tax Court concluded that its original opinion in *O'Neill*, echoed by the Federal and Fourth Circuits in *Mellon Bank* and *Scott*, "remain[ed] sound." Pet. App. 29a.

**6.** Petitioner appealed to the Second Circuit. Before that court, the Commissioner relied upon *Scott* and *Mellon Bank*, contending that costs incurred in connection with the administration of trusts and estates are fully deductible only if they are not "commonly" or "customarily" incurred by individual taxpayers. Brief for Appellee at 3-4, 22-24, *Testamentary Trust of William L. Rudkin v. Commissioner*, 467 F.3d 149 (CA2 2006) (No. 05-5151-ag) ("Gov't CA2 Br.") (quoting *Scott* and *Mellon Bank*); see also id. at 22 (arguing

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[20] The Tax Court deems itself bound to follow the decisions of a Circuit Court of Appeals only when an appeal in the case before it lies to the same court. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970).

that the statute "treats as fully deductible only those trust-related administrative expenses that are not natural, customary, or probable outside of the context of trusts."). The Commissioner has long and repeatedly argued that "if a trust-related administrative expense is also customarily or habitually incurred outside of trusts, then it is subject to the two-percent floor." Brief for Appellee at 27, *Mellon Bank v. United States*, 265 F.3d 1275 (CAFed 2001) (No. 01-5015) ("Govt. *Mellon* Br."); Brief for Appellee at 27, *Scott v. United States*, 328 F.3d 132 (CA4 2003) (No. 02-1464) ("Govt. *Scott* Br.").

A two-judge panel of the Second Circuit affirmed, but on reasoning that differed from that of the Tax Court, that urged by the Commissioner, or that adopted by any of the three courts of appeals to have decided the issue previously, each of whose reasoning the court below rejected.[21] The court concluded that the "plain meaning" of the statute "excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust." Pet. App. 11a (emphasis in original); see also Pet. App. 12a-13a. Applying that test, the court ruled that "investment-advice fees are . . . a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust." Pet. App. 12a.

The court of appeals subsequently denied rehearing and rehearing en banc, Pet. App. 31a-32a, and on June 25, 2007, this Court granted certiorari.

7. After this Court granted certiorari in this case, the Commissioner issued a proposed regulation under the authority of 26 U.S.C. § 7805, purporting to interpret § 67(e). 72 Fed. Reg. 41,243, 41,245 (July 27, 2007), Appendix C,

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[21] Judge Sotomayor wrote the opinion, joined by Judge Hall; Judge Feinberg, who was originally on the panel, recused himself after oral argument. See Pet. App. 2a n.*.

Pet. Br. App. 8a-15a (text of notice of proposed rulemaking and notice of public hearing, including full text of proposed regulation 26 CFR 1.67-4).[22] The proposed regulation says that only expenses that are "unique to" trusts and estates are fully deductible, but, remarkably, it defines "unique" to mean that only costs that "*could not have*" been incurred by an individual "in connection with property not held in an estate or trust" are fully deductible. Id. at 13a (Proposed 26 CFR 1.67-4(b)) (emphasis added). That is, the Commissioner has abandoned his longstanding position that the statutory language means that only costs of a type not "commonly" or "customarily" incurred outside trusts are fully deductible. The Commissioner now proposes a position similar to that adopted by the Second Circuit below, that the phrase "would not have been incurred if the property were not held in such trust and estate" should be read to mean "could not have been incurred by an individual." The proposed regulation does not mention or address the fact that this is a departure from the Commissioner's longstanding position with respect to the interpretation of the statute.[23]

Under the proposed regulation, the Commissioner appears to take the position for the first time that the costs for *some* trust investment fees *are*, indeed, deductible in full. The only investment advisory fees that the proposed regulation states it would subject to the two-percent floor are fees paid for "advice on investing for total return," that is investing to achieve the largest return without regard to whether that return is the result of production of income or apprecia-

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[22] The Commissioner informed the Court prior to the grant of certiorari in this case that issuance of a proposed regulation was imminent. See Brief of Respondent in Opposition ("Opp.") at 5-6 (stating that a notice of proposed rulemaking "should be ready for publication in the Federal Register by July 2007").

[23] The notice of proposed rulemaking also does not mention the grant of certiorari in this case, but only the need to resolve the Circuit split on the question presented. Pet. Br. App. 10a-11a.

tion of principal.[24] Pet. Br. App. 14a (Proposed 26 CFR 1.67-4(b)). The proposed regulation specifies that there are circumstances in which only a "portion . . . of the . . . investment advisory" fee may be subject under the regulation to the two-percent floor. Id. 15a (Proposed 26 CFR 1.67-4(c)).

Under modern portfolio theory, individuals are supposed to invest for "total return," but many trusts and estates traditionally could not because of their need for both income and growth of principal in order to "balance the competing interests of differently situated beneficiaries." Restatement 3d § 227 cmt. c, at 13. Thus, "only when beneficial rights do not turn on a distinction between income and principal is the trustee *allowed* to focus on total return . . . without regard to the income component of that return." Id. cmt. i, at 35 (emphasis added). See also id. §§ 183, 232, 239, 240 (describing duty of trustee to deal impartially with beneficiaries and to balance income and principal to serve interests of successive beneficiaries ).

The line proposed by the Commissioner indicates that he now recognizes that trust investment advice fees are not subject to the two-percent floor when they purchase advice about investing in a manner distinct from that undertaken by individuals. See also Pet. App. Br. 13a (determination of deductibility under the proposed regulation turns on "the type of product or service rendered to the estate or trust"). As described above, they always do.

## SUMMARY OF ARGUMENT

Like other significant income producing entities, trusts and estates have long been permitted to deduct for income tax purposes investment advice fees paid to assist with the management of property held for the production of income. That rule comports with the Revenue Code's broad basic policy to tax only net income. Section 67(e) preserved trus-

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[24] See Restatement 3d § 227 cmt. e, at 18 (defining investment for "total return").

tees' ability to do so. That construction is confirmed by the text, structure and history of the section, the Act in which it was adopted, and the Code of which it is a part. There is no basis for the assertion that Congress intended in § 67(e) to work the significant change to trust and estate taxation that the Commissioner posits, a change that would have serious consequences for the very beneficiaries trusts and estates are designed to protect.

**I.** 26 U.S.C. § 67(e) requires a determination of whether costs incurred in connection with the administration of a trust or estate "would not have been incurred if the property were not held in such trust or estate." This is a straightforward causation test. It means that all expenses that are caused by the fact that the property is held in the trust or estate are deductible in full. Trust investment advice fees are caused by the fact the property is held in trust. They are incurred in fulfillment of the trustee's unique fiduciary duty, a duty not applicable to individuals investing their own funds. The advice for which trustees pay is tailored precisely to the distinctive requirements imposed by that fiduciary duty. By contrast, costs that would be identical regardless of whether the property was owned by an individual or a trust, for example expenses for routine maintenance of real property, are subject to the two-percent floor. This is not only the best reading of the statute's text, it provides a rule that fits coherently within the Internal Revenue Code, serves the purposes intended by Congress, and is workable and fair.

The text and structure of the Revenue Code, the 1986 Act, and § 67 itself confirm this reading. Section 67 was intended to subject expenses with a "personal" aspect to the two-percent floor. Trust investment advice fees do not have this aspect. Congress also did not intend to impose the two-percent floor on trust and estate investment advice expenses to prevent individuals from establishing trusts and estates to circumvent the two-percent floor that would otherwise apply to their deductions. Congress recognized that trusts and estates are not subject to such abuse, and indeed, its consistent

provision, both before and since the 1986 Act, of deductions for costs incurred in connection with the administration of trusts and estates demonstrates that Congress is not concerned about their misuse in that way. It makes the most sense therefore to read § 67(e) to preserve the full deductibility of trust and estate investment advice fees, perhaps the largest single cost incurred in connection with trust and estate administration, rather than to work the significant change to their tax treatment urged by the Commissioner.

**II.** Because the statute has a plain meaning, and no other textually supportable interpretation of § 67(e) has been proposed, this Court need not employ the tools used for addressing statutory ambiguity. However, if the statute were found to be ambiguous, applicable rules of interpretation would support Petitioner's reading. The legislative history of § 67 confirms that Congress did not intend the two-percent floor to apply broadly to trust and estate administrative expenses and that the primary purpose of the limitation in § 67(e) was to address the administrative expenses associated with what is called a "pass-through entity" (for example a partnership) that happens to be owned by a trust or estate. Administrative costs of pass-through entities are not fully deductible when such entities are owned by individuals, and the legislative history of § 67(e) makes clear that the specific purpose of that provision was to ensure that they likewise cannot be fully deducted when the pass-through entity happens to be owned by a trust or estate. Further, if the statute were ambiguous, under a venerable canon of construction it would be necessary to resolve any doubt "against the Government and in favor of the taxpayer." *United States v. Merriam*, 263 U.S. 179, 188 (1923).

**III.** Any construction of the statute under which trust investment management fees are not deductible in full would violate the congressional purpose and would do grave harm both to those who are the beneficiaries of trusts and estates and to the financial services industry by discouraging trustees from engaging the services of precisely the professional

advisors best able to assist them with fulfillment of their fiduciary obligations. This Congress cannot have silently intended.

**IV.** Only Petitioner's interpretation of the statute offers a coherent approach to the Commissioner's longstanding treatment of costs incurred in connection with the administration of trusts and estates. The Commissioner has long taken the position that fees for the preparation of fiduciary income tax returns (but not parallel individual returns) and trust attorney fees (but not individuals' attorney fees), among others, are fully deductible and not subject to the two-percent floor. This can be explained only by the relationship of those particular expenses to the fulfillment of the trustee's fiduciary duty. The same rule should apply with respect to trust investment fees, recognizing their full deducibility because they are, like those other expenses, caused by the fact that the property is held in the trust.

**V.** The statutory language will not support any of the other proposed readings of § 67(e). The Commissioner's new proposed interpretation is obviously textually unsupportable. "Would not have been incurred" simply does not mean "could not have been incurred." In addition, the bewildering difficulty of case-by-case factual determinations and corresponding detailed recordkeeping and auditing under the test now proposed by the Commissioner is utterly contrary to the purpose of § 67 to reduce such costs. The position taken by the Fourth and Federal Circuits, asking not whether a cost actually would "have been incurred if the property were not held in such trust or estate," but whether that type of cost is commonly incurred outside of trusts, is, similarly, both countertextual and unworkable in application.

**VI.** Finally, even under the test adopted by the Fourth and Federal Circuits or the one now proposed by the Commissioner, the trust investment fees in this case would not be subject to the two-percent floor, but would be fully deductible. Individuals do not "customarily" or "commonly" place

assets under management, paying a percentage-of-assets management fee. Further, trust investment fees are peculiar to trusts and estates and cannot be incurred by individuals. Even under the principle articulated in the Commissioner's proposed regulation, the trust investment advice fees in this case would be fully deductible.

## ARGUMENT

### I. EXPENSES CAUSED BY THE FACT THAT THE PROPERTY IS HELD IN TRUST, INCLUDING THE TRUST INVESTMENT ADVICE FEES AT ISSUE HERE, ARE FULLY DEDUCTIBLE UNDER § 67(e).

#### A. The Text of § 67(e) Establishes a Straightforward Causation Test Readily Satisfied Here.

Section 67(e) permits the deductibility in full of "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e). This establishes a straightforward causation test. The text's plain meaning requires an inquiry into whether a particular expense of a particular trust or estate was caused by the fact that the property was held in the trust or estate.

Applying this test, the trust investment advice fees at issue in this case are deductible in full. Trust investment advice fees are caused by the fact that property is held in the trust. They are incurred in fulfillment of the trustee's fiduciary obligation, and the advice for which they pay is tailored precisely to the distinctive requirements imposed by that fiduciary duty. The trust investment management fees in this case, for example, were incurred in order to obtain advice on investing trust assets in compliance with the Trustees' particular fiduciary duties. They purchased something different from similar costs that might have been incurred by an individual. The fees therefore would not have been incurred had the property not been held in trust.

An individual may incur a *similar type* of cost, but an

individual will not incur the trust investment advice costs that are incurred by a trustee to ensure that he or she meets his or her fiduciary responsibilities. The statute does not ask whether similar costs are capable of being incurred by individuals or whether similar costs are customarily or commonly incurred by individuals. Rather, the statute asks whether *these costs would have been incurred* if the property were not held in this trust. The trust investment fees at issue here would not have been.

This common-sense approach to the statute creates a bright-line rule that Congress plainly intended. On one side of the line are costs caused by the fact that the property is held in the trust or estate. These remain fully deductible. On the other side are costs that would have been incurred regardless of who owned the property held in trust – for example, expenses for routine maintenance of real property when it happens to be owned by a trust but could equally have been owned by an individual. In that situation, the expenses are identical regardless of whether the owner is an individual or a trust or estate and in either event they are subject to the two-percent floor. Similarly, the expenses § 67(e) was in fact specifically designed to subject to the two-percent floor, administrative costs associated with certain entities such as partnerships in which a trust or estate, like an individual, may have ownership interests, see *infra* at 32-36, are identical whether the property (there the partnership interest) happens to be owned by an individual or by a trust or estate. (Those costs of what are called "pass-through" entities, including partnerships, will be explained in more detail below.)

**B. The Text and Structure of the Revenue Code, the 1986 Act, and § 67 Itself Confirm This Reading.**

This reading of § 67(e) is confirmed by the legislative history of both § 67(a), imposing the two-percent floor, and § 67(e) itself. See *infra* 31-38 (discussing legislative history). But this Court need not resort to legislative history,

because only this reading of § 67(e) is consistent with the text and structure of the Revenue Code, the 1986 Act and the other provisions of § 67.

**1. Expenses Caused by the Fact Property is Held in the Trust or Estate Lack the Personal Character of the Expenses Whose Deductibility Congress Sought to Limit With the Two-Percent Floor Adopted in § 67.**

The purposes for which the two-percent floor itself was adopted would not be served by imposing it on the costs at issue here.

The Revenue Code reflects a broad basic policy to tax net income. Accordingly, costs like investment management fees, which contribute to the production of income, have long been deductible from the income of individuals and entities alike for income tax purposes. And even when Congress has found reason to limit the deductibility of such costs for individuals, it has retained them for entities like trusts and estates. Thus, before 1986, though Congress had limited the deductibility of such expenses for individuals in calculating their Alternative Minimum Tax (AMT), it preserved the principle of their deductibility in the same circumstances for trusts and estates. See *supra* at 12.

The two-percent floor was concerned with addressing abuse and misapplication of the net income system by individuals. It was included in a Title of the Act entitled "Individual Income Tax Provisions," see 100 Stat. at 2085, and the specific provision imposing it, § 67(a), entitled "General Rule," states that "*in the case of an individual*, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." See id. at 2114, Pet. Br. App. 5a (emphasis added).

As the placement of section 67 in the Act indicates, this two-percent floor is essentially a rule for individuals, and it arises from issues peculiar to individual taxpayers. The two-percent floor was adopted out of a concern that individual

taxpayers were frequently deducting expenses with some "voluntary personal" characteristic, erroneously claiming deductions or deducting expenses that would have been incurred even if they did not contribute to the taxpayer's income-producing activities. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* at 78 (1987) (hereinafter "Blue Book"); see *FPC v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472 (1973) (such a General Explanation provides "a compelling contemporary indication" of the meaning of a statute). This included expenses such as education expenses, subscriptions to business or trade journals, and safe-deposit box fees for boxes that could hold both personal and investment-related items. See Blue Book at 78-79 & n.52.

The two-percent floor on deductions served as a kind of "rough justice" disallowing a fixed part of an individual's miscellaneous itemized deductions in the aggregate on the theory that some portion of the expenses were actually personal in character. It employed the two-percent floor rather than requiring case-by-case determinations in order to reduce the burden upon the IRS and the individual taxpayer imposed by the need to verify that individuals' miscellaneous itemized deductions were properly claimed. Blue Book at 78. On its face, the text of the proviso in § 67(e), too, reveals a purpose to address expenses with a personal aspect, subjecting to the floor costs that would "have been incurred if the property not been held in such trust or estate." *Cf.* Blue Book at 79 ("The use of a deduction floor . . . takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer.")

Applying the two-percent floor to distinct costs that are incurred to satisfy the fiduciary requirements imposed on the trustee would not serve the purpose for which § 67(a) and (e) were designed. These trust expenses do not have a voluntary or personal aspect. Investment fees incurred by trusts are properly treated categorically as a legitimate business ex-

pense of discharging the fiduciary duty to prudently invest trust assets. They are mandated by the existence of the trust fiduciary relationship, and serve only the fiduciary purpose of the trust. See *supra* at 5-10. A limitation on their deductibility would thus be beyond the scope of Congress's purpose in enacting § 67.

**2. The Text and Structure of the 1986 Act and the Code More Broadly Demonstrate a Purpose to Retain the Type of Deduction at Issue Here, Not to Restrict It.**

Consistent with this, the text and structure of the 1986 Act and the Code more broadly demonstrate a purpose to retain the deductibility of fees like those at issue here, not to limit it.

**a.** Other taxable entities, for example taxable corporations, Real Estate Investment Trusts (REITs), and so on, are permitted to deduct for income tax purposes similar investment management fees.[25] This is consistent with the basic policy of taxing net income. Congress has recognized that trusts and estates, like these others, are meaningful entities with substantial economic and societal purposes, and so it makes sense that the deductibility of trust and estate investment advice fees should have been preserved by § 67(e), not limited by it.

Trusts and estates are created by the transfer of assets to a third-party trustee who holds, manages and controls the trust property for the benefit of others, the beneficiaries. Individuals create trusts (and estates) to provide for others and to give them protection. The beneficiaries may, as in this case, include a large number of distinct individuals as well as individuals who are not even yet born.

Trusts and estates thus have substantial economic and societal purposes, including the independent management of

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[25] Taxable corporations and REITs, for example, may deduct such fees as ordinary and necessary trade or business expenses under 26 U.S.C. § 162.

trust assets in the interests of the beneficiaries. Trusts' ability to earn income serves their legitimate societal purposes. Consequently, as this Court explained long ago, the Code "treats the trust as an entity for producing income comparable to a business enterprise . . . and permits deductions of management expenses of the trust. . ." *Bingham's Trust v. Commissioner*, 325 U.S. 365, 374 (1945). The Code has set up a unique system for trust and estate income taxation in their own right that differs from that applicable to individuals. See 26 U.S.C. §§ 641, *et seq.* (Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code).

**b.** The Commissioner does not deny this, nor does he suggest there is any reason Congress would have wanted to impose a two-percent floor on deductibility of trust and estate investment advice fees for its own sake. The Commissioner argues, rather, that Congress imposed this new restriction in 1986 to prevent individuals from abusing trusts and estates by shifting income, placing assets and expenses into trusts and estates to circumvent the two-percent floor that would be applicable to them as individuals. Brief of Respondent in Opposition ("Opp.") at 12.

This argument is based on a misunderstanding of the nature of trusts and estates, of their vulnerability to abuse, and of the design of the Code. The text and structure of the Code and the 1986 Act make clear that § 67(e) should be read as a provision *preserving* the ability of trusts and estates to deduct in full most of the costs incurred in connection with their administration, not as a provision *preventing* the full deduction of what is perhaps the largest single such cost.

There are substantial costs and serious consequences to creating and administering an estate or nongrantor trust (the only kind to which § 67(e) applies) that prevent the creation of a trust (or estate) in order to avoid income taxation in the way the Commissioner posits. Congress has repeatedly recognized these consequences. They militate against the Commissioner's reading of § 67(e).

First, there is a tax cost: The grantor, the person who creates the trust, will ordinarily have to pay a significant transfer tax that diminishes the assets. 26 U.S.C. §§ 2501-2502. Second, the grantor loses ownership of and control over assets placed in the trust; the transfer of assets to a nongrantor trust is irrevocable. Management of the assets is committed to the trustee, not the grantor or beneficiaries, and the trustee is not permitted to manage the property as the grantor would. See *supra* 7-10. In addition, a trust or estate has greater costs for recordkeeping, judicial accountings, and the like.

The costs of creating an estate are even greater: One must also die in order to do so. While they are lumped together in the popular imagination, we are confident no one yet has chosen death over taxes. Yet § 67 applies not only to trusts, but to estates. Given the attendant costs, it is implausible that one would create a trust (or estate) in order to obtain a reduction of adjusted gross income (not a direct reduction of taxes), equal to, at most, two percent of AGI. That tail simply cannot wag the massive dog of nongrantor trust or estate creation.

**c.** More significantly, several other provisions in the Code and, indeed, in the 1986 Act itself, demonstrate that Congress was not concerned with income shifting through the use of nongrantor trusts and estates.

In the 1986 Act, Congress actually included a different provision – § 67(c) – to prevent the kind of income-shifting abuse the Commissioner claims § 67(e) targets. Congress identified the entities that it determined were subject to such abuse, and it *expressly excluded trusts and estates from that list*. There is a category of entities known as "pass-through" entities, common examples of which are partnerships and S corporations. Such entities are not distinct taxpayers; they do not pay tax on their income, but pass their own income through to their owners who pay income tax upon it. See, *e.g.*, 26 U.S.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons

carrying on business as partners shall be liable for income tax only in their separate or individual capacities.") Each owner's share of the entity's income is reported on a Schedule (ordinarily, a "Schedule K-1") that the entity provides to the owner.

If a pass-through entity could deduct something from its income that an individual could not deduct, and then pass its new, reduced net income figure through to its owner, and if it were relatively cost-free to create such an entity, individuals could avoid some of their individual income tax by placing their assets in such pass-through entities. An owner might deliberately shift income and expenses to the entity in this way in order to reduce resulting net income by a deduction to which the owner, *qua* individual, is not entitled.

In § 67, Congress in the 1986 Act prevented this kind of income shifting to pass-through entities that it determined were subject to such abuse, and it explicitly excluded trusts, estates, and certain other entities. Congress did so even though some of the excluded entities may, like pass-through entities, at times distribute net income to beneficiaries who must report it on their own income tax returns. As adopted in the 1986 Act, § 67(c) provided:

> The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection. The preceding sentence shall not apply with respect to *estates, trusts,* cooperatives, and real estate investment trusts.

100 Stat. at 2114, Pet. Br. App. 6a (emphasis added).[26]

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[26] See also 26 CFR 1.67-2T(g) (defining "pass-thru entity"). We note that the variant of trusts known as "grantor trusts" described *supra* at n.1 are treated as pass-through entities as permitted by a 1988 technical amendment to §67(c). See *id*; see also 26 U.S.C. § 67(c).

This provision confirms that § 67(e) should be read as preserving the full deductibility of most trust and estate costs incurred in connection with their administration, not as preventing the deduction of what is perhaps the largest single such cost trusts and estates incur.[27]

And indeed, in other provisions of the Code beyond § 67(e) Congress consistently has permitted expenses incurred in connection with the administration of trusts and estates, including trust investment advice fees, to be deducted from trust and estate income even when similar expenses can not be deducted by individuals. As described above, for example, prior to the enactment of the 1986 Act, § 57(b)(2) allowed deduction of costs incurred in connection with the administration of a trust or estate even when similar costs could not be deducted by individuals. See *supra* at 12. Even more dramatically, § 68 provides that once an individual's adjusted gross income exceeds a certain threshold amount, currently $156,400, most of his or her itemized deductions will be reduced by the lesser of eighty percent of their total

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[27] The structure of § 67(e) confirms that it was not designed to address the risk of abuse through income-shifting. Where Congress did address abuse-prone entities it did so not by imposing a deductibility floor at the entity level, but by requiring the individuals who ultimately received the income to treat their share of the entity's miscellaneous itemized deductions as subject to the two-percent floor on their own individual returns. See 26 U.S.C. § 67(c)(1) (addressing pass-through entities). This makes perfect sense. For to impose the two-percent floor on expenses at the entity level, as the Commissioner would here, could actually result in a disadvantage for those taxpayers who receive income from trusts and estates. This could happen when an individual's aggregate miscellaneous itemized deductions have already met the two-percent floor – so that if the trust investment advice expenses were passed out to the individual separately, he or she could fully deduct them, as the individual would if they were his or her own investment advice expenses. On the Commissioner's reading, if the trust had not met its two-percent floor, these costs could not be deducted at the entity level by the trust, nor could they be deducted by the individual receiving the trust income, since that individual would not be entitled to claim the trust's miscellaneous itemized deductions as his or her own.

or three percent of the amount by which the adjusted gross income exceeds that threshold. 26 U.S.C. § 68; see also Rev. Proc. 2006-53, 2006-48 I.R.B. 996, *as modified by* Rev. Proc. 2007-36, 2007-22 I.R.B. 1335 (adjusting threshold amount for inflation). This is a parallel provision to § 67, and it, like § 67, reduces the extent to which individuals are able to deduct certain of the itemized deductions. See 26 U.S.C. § 68(a), (c). Yet 26 U.S.C. § 68(e) provides that "[t]his section shall not apply to any estate or trust."

In light of all this, it cannot sensibly be maintained that Congress intended in § 67(e) to eliminate the full deductibility of trust and estate investment management fees because of concern about abuse hypothesized if trusts and estates were allowed to deduct such fees from their income. The text and structure of the statute thus indicate that § 67(e) should be read to preserve the deductibility in full of trust investment advice fees, not to prevent it.

## II. IF THERE WERE AMBIGUITY IN § 67(e), THE TOOLS APPROPRIATELY USED TO RESOLVE IT WOULD ALL SUPPORT PETITIONER'S READING

The statute has a "plain meaning," despite the confusion about its construction among the courts of appeals. And, indeed, as we will demonstrate below, none of the other proposed constructions of the statute are even textually supportable. See *infra* at 44-48. There is thus ultimately no ambiguity in the statute requiring inquiry beyond its text and structure. If this Court were nonetheless to find the statute ambiguous, the tools appropriately used to resolve statutory ambiguity, both the legislative history and the canons of construction, support the construction of the language we have put forward.

### A. Legislative History.

Most significantly, the legislative history of § 67 confirms that Congress did not intend the two-percent floor to apply as the Commissioner urges. It makes clear that the primary purpose of the second prong of § 67(e) was to pre-

vent the deduction of administrative expenses incurred by pass-through entities in which trusts or estates happened to have an interest. See H.R. Conf. Rep. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122. These and similar costs that have nothing to do with the fiduciary's unique obligations are the only ones subjected to a two-percent floor by the statute.

**1.** In both the original House and Senate versions of the bill, what became § 67(e) did not contain a second prong. In both versions, it read simply "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income." See H.R. 3838, 99th Cong., 1st Sess., § 132 (as passed by the House, Dec. 17, 1985); H.R. 3838, 99th Cong., 2d Sess., § 133 (as passed by the Senate, June 24, 1986), *reprinted at* 132 Cong. Rec. 16,061, 16,070 (June 26, 1986). Congress thus clearly intended as an initial matter to continue its policy of allowing trusts and estates this deduction in full "above-the-line" for the costs incurred in connection with their administration.

**2.** Further, the legislative history of § 67(a) indicates what has already been discussed: the two-percent floor was adopted out of a concern that taxpayers were frequently deducting expenses with some "personal" aspect, erroneously claiming deductions or deducting expenses that would have been incurred even if they did not contribute to the taxpayer's income-producing activities. See S. Rep. 99-313, at 78-79 (1986). The two-percent floor was intended to address both such deductions and the burden upon the IRS and the taxpayer imposed by recordkeeping requirements for determining and verifying that certain miscellaneous itemized deductions were properly claimed. See H.R. Rep. 99-426, at 109-110 (1985); S. Rep. 99-313, at 78-79. As described above, the two-percent floor on deductions served as "rough justice" for disallowing that part of miscellaneous itemized

deductions assumed to be "personal."

Permitting the deduction in full of most administrative expenses incurred by trusts by reason of the trust's existence was an implicit recognition that these expenses do not contain a personal aspect. It also reflected the policy determination that ordinary trust operations do not present the potential for abuse that was addressed by the two-percent floor, a policy determination prominent in the statute as it was adopted. See 26 U.S.C. § 67(c) (1986), Pet. Br. App. 6a.

**3.** The second prong of § 67(e) – the limitation on the deduction allowed by the provision – was added only in the Conference Committee. The history of its adoption makes clear that it was intended primarily to address the problem of trust and estate treatment of administrative costs passed through to the trusts or estates by pass-through entities in which they happened to have an ownership interest.

As described above, the 1986 Act included a provision to restrict the ability of individuals indirectly to deduct costs of pass-through entities in which they had an ownership interest when those costs would not have been deductible in full had the individuals incurred them themselves. 26 U.S.C. § 67(c). One of the effects of the second prong of § 67(e), indeed, the one about which the enacting Congress was specifically concerned, was to impose a parallel restriction on pass-through entity expenses when those entities happened to be owned by trusts and estates. If a trust is a partner or shareholder in a pass-through entity, that entity can incur expenses in its administration, and pass them through to the trust, reporting them on the schedule sent to the trust. The trust can then record those costs as administrative expenses on its own tax return. Section 67(e) ensures that, when a trust owns an interest in a pass-through entity, these costs are subject to the two-percent floor.

The Conference Committee action with respect to § 67 was focused on pass-through entities. Neither the version of the Act passed by the House nor that reported out of the Sen-

ate Finance Committee included any language limiting the use of pass-through entities to avoid limitations on individual deductions, though both exempted all costs incurred in connection with the administration of trusts and estates from the limits on deductibility imposed on individuals. On the very day the Senate passed its version of the Act, it first passed a floor amendment introduced by Sen. Packwood that read

> The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual.

132 Cong. Rec. 15,156 (June 24, 1986). This was the first time pass-through entity costs were addressed in the context of limiting individual use of itemized deductions.

The Conference Committee adopted this language from the final Senate bill, but it had to harmonize it with, among other things, the provision allowing deductions for trust and estate costs incurred in connection with their administration. It did so first by adding to the pass-through restriction that became § 67(c) the language expressly *exempting* trusts and estates from being themselves treated as pass-through entities: "The preceding sentence shall not apply with respect to estates, trusts, cooperatives, and real estate investment trusts." 100 Stat. at 2114, Pet. Br. App. 6a. This preserved the benefit of the special rule allowing trusts and estates to deduct costs incurred in connection with their administration. Second, though, the Senate pass-through provision adopted by the Conference Committee also applied only to "individual[s]" deducting the costs of pass-through entities. See *supra* this page. So, to ensure that the pass-through entity's costs were no more deductible when passed through to trusts and estates than they were when passed through to individuals, the Committee added the second prong to § 67(e) providing that a trust or estate could not deduct costs incurred in connection with administration if the cost would "have been incurred if the property were not held in such trust or estate."

And indeed, the legislative history of the second prong of § 67(e), which lies solely in the Conference Report, makes clear that this was Congress's purpose:

> Pursuant to Treasury regulations, the [two-percent] floor is to apply with respect to indirect deductions through pass-through entities. . . . In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid and incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. *The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.*

H.R. Conf. Rep. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122 (emphasis added).

This language – the only congressional explanation ever given for the second prong of § 67(e), and the most authoritative legislative history there could be[28] – makes clear that the second prong was designed to prevent trusts from deducting in full the administrative expenses incurred by pass-through entities in which they held an ownership interest that would have been incurred whether or not the pass-through interest was held in the trust. Section 67(e) means that when a trust owns an interest in a pass-through entity, such costs of

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[28] See, *e.g.*, *Railway Labor Executives Ass'n v. ICC*, 735 F.2d 691, 701 (CA2 1984) (Friendly, J.) (citation omitted) ("Because the conference report represents the final statement of terms agreed to by both houses, next to the statute itself it is the most persuasive evidence of congressional intent.").

pass-through entities they own are subject to the two-percent floor. That is why, as the legislative history explains, its effectuation required the Secretary to take account of § 67(e) in reporting requirements relating to application of the floor to expenses of pass-through entities. The reporting requirements issued by the Treasury to implement the statutory command that pass-through entity costs were to be subjected to the two percent floor by their owners who were individuals would have to be crafted to address the rule enacted in § 67(e) under which pass-through entity costs would also be subjected to the two-percent floor limitation when the pass-through entity was owned by a trust or estate.

The legislative history thus confirms our reading of the statute. Section 67(e) was enacted to impose the two-percent floor on costs incurred in connection with the administration of trusts and estates that were not caused by the property being held in the trust or estate, but that would have been incurred regardless of the property's ownership, archetypally the administrative costs of pass-through entities. There is no indication at all in the legislative history that the Conference Committee intended instead to depart from the position already taken by both Houses of Congress in the versions of the bill they had passed: That the pre-existing tax treatment of trusts and estates would be continued by permitting an above-the-line deduction for most costs incurred in connection with trust and estate administration. The legislative history makes clear that Congress simply did not intend the significant change in the taxation of trusts and estates that would have been wrought by a restriction on the deduction of what is perhaps the largest single such expense, fees for trust and estate investment advice.

**4.** By contrast, the legislative history long relied upon by the Commissioner is irrelevant to the provision before the Court. The Commissioner says

> Congress . . . sought to reduce the tax benefit of placing assets in trust in order to split income between the

> trust and its beneficiaries, primarily by setting the tax rates for trusts so that little income could be sheltered at the lower rates. See 26 U.S.C. 1(e); S. Rep. No. 313, *supra*, at 867-868. Making the 2% floor for miscellaneous itemized deductions applicable to trusts (with an exception for trust-related administrative expenses that would not have been incurred if the property were not held in a trust) also serves that goal by preventing trusts from fully deducting the same expenses that individuals cannot fully deduct.

Opp. at 12.

No one would deny that Congress set the tax rates for trusts in 26 U.S.C. § 1(e) in such a way as to discourage splitting income. Under that provision trusts and estates currently reach the top 35% tax bracket with undistributed taxable income of more than $10,050, while individuals need to have more than $349,700 of taxable income to be taxed at the highest rate. See 26 U.S.C. § 1(a)-(e); Rev. Proc. 2006-53 § 3.01, 2006-48 I.R.B. 996, *as modified by* Rev. Proc. 2007-36, 2007-22 I.R.B. 1335. But that (and the inapposite Senate Report describing it cited by the Commissioner) has nothing to do with the two-percent floor, or the meaning of the second prong of § 67(e). Indeed, the Senate Report the Commissioner cites states that the Committee "believe[d] that significant changes in the taxation of trusts or estates" beyond the new rate schedule were "unnecessary" to address "the tax benefits which result from the ability to split income between a trust or estate and its beneficiaries." S. Rep. 99-313 at 868 (1986). Section 67(e) is designed precisely to allow some miscellaneous itemized deductions to be deductible in full by trusts and estates, even though for an individual all such deductions are subject to the two-percent floor. The only question of legislative purpose actually implicated here is why the Congress added the second clause to § 67(e). And that is answered by the legislative history described above.

**B. Canons of Construction**

Canons of statutory construction applicable to the interpretation of ambiguous statutes also favor the position taken by Petitioner.

This is a tax statute. There is of course a longstanding and "traditional canon that construes revenue-raising laws against their drafter." *United Dominion Indus. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring). As this Court has explained, in construing a revenue statute, "[i]f the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer." *United States v. Merriam*, 263 U.S. 179, 188 (1923).

The Commissioner has argued, citing *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992), that "[b]ecause deductions are matters of legislative grace, they are strictly construed, and any vagueness in a Code section authorizing a deduction must be resolved in favor of the Government." Gov't CA2 Br. 18.

Even if that were a viable, broadly applicable rule of construction it would not apply here. There is no question that the fees at issue here qualify as "miscellaneous itemized deductions." The only question is whether they are allowable in full or subject to the two-percent floor. Further, the dispute is over the applicability *vel non* of an *exclusion* from a rule of full deductibility. Thus, this case does not involve a determination of the scope of a deduction in light of a background rule that the income in question is to be taxed. It involves the determination of the scope of an exception in light of a background rule that costs of this type are fully deductible.

In any event, as this discussion may suggest, the rule described in *INDOPCO* is not a viable, broadly applicable canon of construction. In *INDOPCO*, the Court applied the canon of resolving doubt against deductibility only in the context of determining whether a particular expense was deductible or was instead a capital expenditure to be amortized

and depreciated, and it did so only after examining the statute to find a "norm of capitalization." 503 U.S. at 84. The Court acknowledged that it was "*[i]n exploring the relationship between deductions and capital expenditures*" that it had "noted the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" Id. (emphasis added). Thus, the Court said that in that one context "deductions are strictly construed and allowed only 'as there is a clear provision therefor.'" Id. (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940)).

By contrast, the cases *INDOPCO* quoted and cited are all over sixty years old. Outside of this narrow context, this Court appears not to have relied upon the canon based upon deductions being a matter of "legislative grace" since *Equitable Life Assurance Society v. Commissioner*, 321 U.S. 560 (1944). Before *INDOPCO* it was last *cited* by this Court over thirty years ago. See *Commissioner v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 148 (1974). Indeed, this Court has viewed this alleged rule of construction of deductions with skepticism since at least 1952, when it pointedly declined to rely upon it in *Lykes v. United States*, 343 U.S. 118, 120 n.4 (1952) (citing Griswold, *An Argument against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142 (1943)).

Of course, as Justice Thomas's concurrence in *United Dominion Industries* suggests, the idea that deductions must be construed *against* the taxpayer is at most a vestige of another era, when it was thought that *not* taxing someone's income was an act of "legislative grace." Whether done through narrow interpretations of deductions or through broad interpretations of a tax, the employment of an ambiguous statute to impose tax upon an individual is an assertion of power by the State to make a claim upon some of his or her income without a clear expression of congressional in-

tent. The canon that revenue laws must be construed against the government has equal force in both circumstances. See 522 U.S. at 839 (Thomas, J., concurring). The canons of construction applicable in cases of statutory ambiguity thus favor Petitioner's reading of the statute.

## III. AN ALTERNATIVE CONSTRUCTION WOULD WORK SUBSTANTIAL DETRIMENT TO BENEFICIARIES AND THE FINANCIAL SERVICES INDUSTRY.

Any construction of the statute that forbids full deduction for trust investment fees would have serious consequences that Congress could not have intended for beneficiaries and the financial services industry.

Of course, the imposition of this tax would consistently erode trust corpus, and thus the earnings thereon, not just once, but in cumulative fashion, year after year. That would be a direct harm to the beneficiaries that trusts and estates exist to protect. Further, though, if fees for investment advice were no longer fully deductible, trustees would have an incentive to attempt to fulfill their fiduciary responsibilities of prudent investment without incurring investment management and advice fees subject to the two-percent floor. This would be harmful both to beneficiaries and to the financial services industry.

Some, particularly smaller trusts, may take their assets out of management and attempt to invest them in mutual funds, the costs of which are always deductible under 26 U.S.C. § 67(c)(2). Indeed, commentators have urged this approach since the decision below was handed down. See Cohen, *A Tense Time for Trust Administration*, 146 Trusts and Estates 28, 29 (2007). Others may try to use brokers, who typically charge only commissions for purchases and sales. These commissions are included in the cost basis for securities and deducted from the gain upon sale so that they are, effectively, excluded from taxable income. See 26 CFR 1.263(a)-2(e). Many will also likely seek trustees who are

themselves skilled in investment, so that no separate investment advice and management fee need be incurred, but the fee will be built into deductible "trustee fees." This is an approach that has been described repeatedly in the literature.[29]

A trustee must always fulfill his or her fiduciary obligations, but it would make little sense for Congress to have created an incentive for one method of trust and estate investment over another. An affirmance of the decision below would be harmful both to the beneficiaries for whom the trusts were created in the first place, and to the financial services industry whose professionals may be best able to assist with fulfillment of fiduciary obligations and to ensure that trusts and estates are managed appropriately in light of their purposes. *Cf.* Brief *Amici Curiae* of the American Bankers Association, *et al.*, in Support of Petition for Certiorari 6.

## IV. ONLY PETITIONER'S CONSTRUCTION OFFERS A COHERENT APPROACH TO THE INTERNAL REVENUE SERVICE'S LONGSTANDING TREATMENT OF COSTS INCURRED IN CONNECTION WITH THE ADMINISTRATION OF TRUSTS AND ESTATES.

Only the principle of full allowability for costs caused by the fact that the property is held in the trust or estate can adequately explain the Commissioner's own longstanding position with respect to a wide range of costs incurred in connection with the administration of trusts and estates. Indeed, the principle we advocate here is the same one that

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[29] See, *e.g.*, Satchit, *Estates, Trusts & Gifts: Trusts, Investment Advisory Fees and the 2% Floor*, Tax Adviser, Feb. 2004 at 87, 88; Hohos, *Fees Paid By Trustees For Investment Strategy Advice and Management Services are not Deductible Under Section 67(e)(1)*: Mellon Bank, N.A. v. United States, 54 Tax Law. 693, 699 (2001). It has been the Commissioner's longstanding position that "trustee fees" are deductible, see, *e.g.*, Opp. at 11, even though these are fees that are paid by the trust to the trustee himself or herself primarily for managing the trust assets. The Commissioner's new proposed regulation does not directly address trustee fees. See *infra* n.32.

animates the Commissioner's treatment of all such expenses except for those at issue here, expenses for trust and estate investment advice.

Thus, the Commissioner's position consistently has been that fees for income tax preparation incurred by trustees are fully deductible, even though income tax preparation fees are routinely incurred by individuals and are subject to the two-percent floor. See Opp. 11; Levin, *Limitation on Deductions for Trusts: What Should a Trustee Do?*, 111 Tax Notes 445, 453 (Apr. 24, 2006) ("Income tax return preparation fees . . . are not unique to trusts or estates."). This position is reiterated in the Commissioner's proposed regulation. See Pet. Br. App. 14a. Similarly, the Commissioner has long taken the position that legal fees and accounting fees incurred by trusts are fully deductible, even though the same types of fees are commonly incurred by individuals, for whom they are subject to the two-percent floor. See id. Indeed, there is a line on the Form 1041 for the full deduction of "attorney, accountant and return preparer fees" under § 67(e). See J.A. 12 (line 14).

The Commissioner's attempts to distinguish these expenses and to explain the meandering line he has drawn in practice rest upon the inappropriately broad level of generality in his description of trust investment advisory fees. He has thus called the fees at issue in this case "fees for investment advice," Opp. at 10; see also Gov't CA2 Br. 11 (describing this as a cost "of a type that would customarily be incurred outside the context of trusts").[30] Costs that he has historically allowed in full, however, he describes more narrowly. In his proposed regulation, he thus, for example, describes trust legal fees as fees for services rendered in connection with "judicial . . . filings *required as part of the administration of the trust or estate*." Pet. Br. App. 14a (em-

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[30] As described above, the Commissioner's latest proposal is that only fees for "advice on investing for total return," are subject to the two-percent floor. Pet. Br. App. 14a.

phasis added), and trust income tax preparation fees as fees for services rendered in connection with "*fiduciary* income tax" returns. Id. (emphasis added).[31] That more particular approach is what the statute, in asking about specific costs, properly requires. The correct way to describe the fees at issue here is "investment advice fees required as part of the administration of the trust or estate," or "trust investment advice fees."

A rule of law must be applied in a principled manner, or it is no rule of law at all. *Cf.* Scalia, *The Rule of Law as a Law of Rules*, 56 U. Chi. L. Rev. 1175 (1989). And this Court has made clear that, where tax law is concerned, substance is what matters, not labels. See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). The costs the Commissioner allows are, indeed, fully deductible – and as his treatment of them suggests, trust investment advice fees are as well. The only principled explanation for construing § 67(e) to permit the Commissioner's preferred deductions-in-full is that those particular expenses are caused by the fact that the property is held in the trust or estate. They purchase services for the trust or estate that differ in character from

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[31] The Commissioner has also suggested that preparation of a fiduciary income tax return is an "additional" cost created by the trust because an individual would have to prepare an individual income tax return whether or not he or she held the property that is now held in the trust. Opp. at 11. Contrary to the Commissioner's suggestion, an individual is not required to file an income tax return simply because he or she exists. Individuals, like trusts, are required to file income tax returns – and therefore may incur fees for their preparation – only when they have income above a certain amount. See 26 U.S.C. § 6012(a)(3)-(4) (in general only trusts with gross income above a certain amount or with some "taxable income" need file fiduciary income tax returns); id. § 6012(a)(1) (only individuals with income above a certain amount need file income tax returns). If the trust, with no other assets or income, were to turn the trust property over to a similarly situated individual, that individual would be required to file an individual income tax return – and thus perhaps to incur a fee for the preparation of such a return – only because of his or her ownership of that income-producing property.

similar services purchased by individuals. Those particular costs, therefore would not have been incurred if the property had not been held in the trust in question, though similar costs may, and often are, incurred by individuals. The same principle applies to Petitioner's costs in issue here.[32]

## V. THE OTHER PROPOSED READINGS ARE NOT TEXTUALLY PLAUSIBLE.

The statutory language will not support any of the other proposed readings of § 67(e).

### A. The Commissioner's New Proposed Interpretation is Textually Unsupportable.

The Commissioner has now abandoned his longstanding position that only expenses commonly or customarily incurred outside trusts may be deducted in full. While this presumably reflects his recognition that the position he has taken in the past and throughout this litigation was wrong, the position he has now adopted and that was taken by the court below is similarly incompatible with the statute's text.

Section 67(e) provides that the trust's administrative expenses are fully deductible so long as they "*would not* have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e) (emphasis added). The Commis-

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[32] The Commissioner has argued that "trustee fees" are deductible, even though they primarily purchase investment management services. See, Opp. at 11. The reason a trust's payment of such fees should, indeed, be fully deductible is that the cost is incurred because a trustee's services are needed to fulfill the fiduciary duties imposed by the trust. A trust purchases a service that individuals do not need: management of the trust in accord with state law and the terms of the trust. The "delegat[ion of] investment and management functions" by the fiduciary, here the Trustees, to an agent, here Warfield, cloaks the agent with the fiduciary's obligations as a matter of law. See Conn. Gen. Stat. § 45a-541i Perhaps because it is impossible to defend allowing a full deduction for trustee fees while disallowing a full deduction for trust investment fees like those at issue here, the Commissioner's proposed regulation, which categorizes many examples of different costs, does not specifically mention trustee fees at all. See Pet. Br. App. 14a-15a.

sioner's new proposed reading is that a cost is deductible only "if an individual *could not* have incurred that cost in connection with property not held in an estate or trust." Pet. Br. App. 14a (emphasis added); see also Pet. App. 13a (Second Circuit concluding "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.").

This is just wrong. "Would" simply does not mean "could." And a conclusion that a cost "would not" have been incurred in a particular circumstance does not mean that it "could not" have been. This interpretation had its genesis in the Second Circuit, which cut it from whole cloth. This is not a reading the Commissioner urged in that court – presumably because it flatly contradicts the text of the statute.

Further, this new proposed construction would render a portion of § 67(e) superfluous. The clause in question reads "the deductions for costs *which are paid or incurred in connection with the administration of the estate or trust and* which would not have been incurred if the property were not held in such trust or estate. . ." shall be treated as allowable. 26 U.S.C. § 67(e) (emphasis added). The language italicized in the quotation above, however, would be superfluous under the reading now proposed by the Commissioner.

Costs that "an individual *could not* have incurred . . . in connection with property not held in an estate or trust" within the definition put forward by the Commissioner include only costs "paid or incurred in connection with the administration of the estate or trust," as required by § 67(e)'s first prong. Thus, if the second prong meant what the Commissioner claims, the statute need not have included the first prong at all. In construing statutes, a court of course must "give effect, if possible, to every clause and word of a statute." *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (internal quotation marks and citations omitted). "It is a cardinal principle of statutory construction that a statute ought, upon

the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (internal quotation marks and citation omitted).

Finally, the new test proposed by the Commissioner would be utterly, even absurdly, unworkable. One can see this in the line the proposed regulation draws requiring "unbundling" of costs for "advice on investing for total return." Pet. Br. 14a. If a single trust investment advice fee included some portion attributable to such advice and some portion attributable to advice on investing for some other objective, under the Commissioner's reading only the former portion would be subject to the two-percent floor. The rest would presumably be deductible in full. The task of documenting which expenses lie where, or of identifying the portion of fees that are on one side of the line under the newly proposed test and the portion that are on the other, or of auditing those questions, would each be almost insurmountable. Section 67 was enacted to eliminate precisely such burdens, not to create new and even more dramatic ones.

**B. The Statute Does Not Ask Whether Costs are of a Type That Are "Customarily" Incurred Outside Trusts and Estates.**

The statute also cannot bear the meaning given it by the Fourth and Federal Circuits, that costs of a type customarily or commonly incurred outside of trusts are subject to the two-percent floor. Indeed, the Commissioner essentially has conceded as much in abandoning this, his longstanding interpretation of the statute, in his proposed regulation. Compare Pet. Br. App. 14a with Govt. CA2 Br. 3-4, 22-24; Govt. *Scott* Br. 27, and Govt. *Mellon* Br. 27.

The statute does not ask whether a cost incurred in connection with the administration of a trust is of a type "customarily" or "commonly" incurred outside of trusts. It asks whether the cost would or "would not have been incurred if the property were not held in such trust or estate." 26 U.S.C.

§ 67(e). The statute's plain language, again, will not bear the suggested reading.

The Courts of Appeals that adopted that test did so only because they mistakenly thought any other test would render the second prong of § 67(e) superfluous. See *Mellon Bank*, 265 F.3d at 1280-81 ("under Mellon's construction, the second prerequisite of section 67(e)(1) would be rendered superfluous"); *Scott*, 328 F.3d at 140 ("to give effect to [the second clause of §67(e)] we must hold that the investment advice fees incurred by the trust do not qualify for the exception. . ."). 

These courts, however, were wrong about this feared superfluity. As described above costs incurred in connection with the administration of the trust or estate that are attendant upon ownership of property and that would be incurred by any owner are subject to the two-percent floor. This includes costs like the costs of maintaining real property that happens to be owned by the trust or estate. It also includes administrative costs that have been passed through to the trust from so-called "pass-through entities" in which the trust has an ownership interest.

In the absence of a superfluity problem, there is literally nothing in the language of the statute to commend, or in fact permit, the Fourth and Federal Circuit's reading. And indeed, this proposed interpretation seems to derive solely from a mistaken use of one of the dictionary definitions of the word "would." The Commissioner began arguing long ago that "if a trust-related administrative expense is also customarily or habitually incurred outside of trusts, then it is subject to the two-percent floor." Govt. *Mellon* Br. 27; see Govt. CA2 Br. 22. That assertion has been based solely on the premise that "the verb 'would' . . . . expresses such concepts as custom, habit, natural disposition or probability." Gov't *Mellon* Br. at 27 (citing two dictionaries); Govt. CA2 Br. at 22 (same).

But that is obviously not the sense in which the word

"would" is used here. See, *e.g.*, Merriam-Webster Collegiate Dictionary 1445 (11th ed. 2003) (giving as an example of the use of the word "would" to "express custom or habitual action" the phrase "we would meet often for lunch"); Webster's New International Dictionary of the English Language 2955 (2d ed. 1958) (describing the use of "would" to describe custom or habit as a "special use"); see also *Commissioner v. Soliman*, 506 U.S. 168, 174 (2004) (citation omitted) (stating that "[i]n interpreting the meaning of the words in a revenue Act, we look to the '"ordinary, everyday senses"' of the words," and relying upon a dictionary definition to confirm the statute's meaning). The statute is not asking about what happened in the past customarily or habitually. It is asking concretely with respect to the particular trust or estate whether the cost at issue is one "which would not have been incurred if the property were not held in such trust or estate."

Finally, the test previously urged by the Commissioner and adopted by the Fourth and Federal Circuits would also be unmanageable, and Congress cannot have intended that. If determining whether a cost "would not have been incurred if the property were not held in such trust or estate" requires examining what individuals "commonly" or "customarily" do in like circumstances, the statute could require a trial in virtually every case to determine what individuals customarily do in various particular factual situations. Nor is it at all clear upon what evidence a court could rely in answering the question what costs individuals "customarily" incur in the myriad variable fact patterns that will be presented by different trusts. It is perhaps for this reason that the Commissioner has now abandoned this construction of the statute.[33]

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[33] Because the Commissioner's proposed regulation is just that, a proposed regulation, it would of course even in the face of statutory ambiguity not be entitled to deference of any kind. Notice and comment on tax regulations typically stretches into a several-year process. See, *e.g.*, 26 CFR 1.643(b)-1 (notice of proposed rulemaking issued February 15, 2001, final regulation published January 2, 2004). Sometimes it can take

## VI. EVEN UNDER THE OTHER PROPOSED READINGS OF THE STATUTE, THE TRUST INVESTMENT FEES HERE WOULD BE FULLY DEDUCTIBLE.

Finally, even if this Court were to adopt the Fourth and Federal Circuit's reading of the statute, or that adopted by the Second Circuit and contained in the Commissioner's proposed regulation, the judgment below would have to be reversed because the fees at issue here would nonetheless be fully deductible.

First, it is not "common" or "customary" for individuals to place their assets under management and to incur percentage-of-assets annual investment advice fees similar to the ones imposed upon the Rudkin Trust here.[34] Indeed, the Commissioner has never produced any evidence suggesting that it is. To the extent individuals have liquid assets and the discipline or propensity to invest (even beyond the most

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as long as fifteen years. See, *e.g.*, 26 CFR 1.401(a)(9)-1 (notice of proposed rulemaking issued July 27, 1987, final and temporary regulations published April 17, 2002). Adoption of the proposed regulation will likely face enormous opposition from the most important relevant elements of the bar, the financial services industry, and the public. See, *e.g.*, Reply Brief on Petition for Certiorari App. 10a (recommendation of the American Bar Association Section on Real Property, Probate and Trust Law); Brief *Amicus Curiae* of the Tax Section of the Florida Bar; Brief *Amicus Curiae* of American Bankers Association, *et al.*

Final regulations issued under the authority of 26 U.S.C. § 7805 that are reasonable are entitled not to *Chevron*, but to the weaker *National Muffler* standard of deference. *Boeing Co. v. United States*, 537 U.S. 437, 448 (2003) (citations omitted); see Salem, *et al.*, *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 Tax Law. 717, 761-763 (2004) (Court adheres to *National Muffler* rather than *Chevron* in cases involving interpretive tax regulations). An agency construction like the one contained in the proposed regulation that is contrary to the text of the statute by definition would not be a "reasonable" one. Whatever ambiguity § 67 might be said to have, it is clear the word "would" in § 67(e) does not mean "could."

[34] Petitioner argued below that management fees were not commonly or customarily incurred by individuals, an argument the court of appeals did not reach because of its adoption of the incorrect standard. Pet. 27.

common investment, real estate), they appear most frequently to invest in mutual funds; others invest in certificates of deposit; some also invest in individual stocks, ordinarily with the assistance of a broker. The costs associated with these transactions are not subject to the two-percent floor. See *supra* at 40. Exceedingly few individuals put their assets under management. Incurring fees for investment advice from a money manager is unusual; it certainly is not "common," nor, *a fortiori*, is it "customary."

Nor would these fees be subject to the two-percent floor under the test articulated by the Commissioner in his proposed regulation and described by the Second Circuit. Trust investment advice fees like those incurred here, compelled by the need for investment of funds consistent with fiduciary obligations, are peculiar to trusts and estates. It is not only the case that they would not have been incurred had the property here not been held in the Rudkin trust. Such fees cannot be incurred by an individual. See *supra* at 5-10. And indeed, in limiting the description in his proposed regulation of investment advice fees subject to the two-percent floor to those for "advice on investing for total return," the Commissioner concedes that under his own proposal only fees for investment advice that is the same as that geared to individual investors is subject to that floor. Since the fees in this case were not for advice so geared, they would be fully deductible even under the principle he has articulated.[35]

## CONCLUSION

The judgment of the Second Circuit should be reversed.

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[35] Were this Court to adopt one of these standards, therefore, at the very least a remand would be required to permit its proper application by the court of appeals.

Respectfully submitted,

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# APPENDIX A
## 26 U.S.C. § 67 (2007)

### § 67. 2-percent floor on miscellaneous itemized deductions

**(a) General rule**

In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

**(b) Miscellaneous itemized deductions**

For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than—

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

**(c) Disallowance of indirect deduction through pass-thru entity**

**(1) In general**

The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection.

**(2) Treatment of publicly offered regulated investment companies**

**(A) In general**

Paragraph (1) shall not apply with respect to any publicly offered regulated investment company.

**(B) Publicly offered regulated investment companies**

For purposes of this subsection—

**(i) In general**

The term "publicly offered regulated investment company" means a regulated investment company the shares of which are—

(I) continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(II) regularly traded on an established securities market, or

(III) held by or for no fewer than 500 persons at all times during the taxable year.

**(ii) Secretary may reduce 500 person requirement**

The Secretary may by regulation decrease the minimum shareholder requirement of clause (i)(III) in the case of regulated investment companies which experience a loss of shareholders through net redemptions of their shares.

**(3) Treatment of certain other entities**

Paragraph (1) shall not apply—

(A) with respect to cooperatives and real estate investment trusts, and

(B) except as provided in regulations, with respect to estates and trusts.

**(d) Impairment-related work expenses**

For purposes of this section, the term "impairment-related work expenses" means expenses—

(1) of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and

(2) with respect to which a deduction is allowable under section 162 (determined without regard to this section).

**(e) Determination of adjusted gross income in case of estates and trusts**

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—

(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and

(2) the deductions allowable under sections 642(b), 651, and 661,

shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

**(f) Coordination with other limitation**

This section shall be applied before the application of the dollar limitation of the second sentence of section 162(a) (relating to trade or business expenses).

## APPENDIX B

### 26 U.S.C. § 67 (1986) as adopted in Pub. L. No. 99-514, § 132(a), 100 Stat. 2085, 2113 (1986)

SEC. 67. 2-PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS.

(a) GENERAL RULE.—In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

(b) MISCELLANEOUS ITEMIZED DEDUCTIONS.—For purposes of this section, the term 'miscellaneous itemized deductions' means the itemized deductions other than—

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165,

(4) the deduction under section 170 (relating to charitable, etc., contributions and gifts),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) the deduction under section 217 (relating to moving expenses),

(7) any deduction allowable for impairment-related work expenses,

(8) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(9) any deduction allowable in connection with personal property used in a short sale,

(10) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(11) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(12) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(13) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

(c) DISALLOWANCE OF INDIRECT DEDUCTION THROUGH PASS-THRU ENTITY.—The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection. The preceding sentence shall not apply with respect to estates, trusts, cooperatives, and real estate investment trusts.

(d) IMPAIRMENT-RELATED WORK EXPENSES.—For purposes of this section, the term 'impairment-related work expenses' means expenses—

(1) of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and

(2) with respect to which a deduction is allowable under section 162 (determined without regard to this section).

(e) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the

property were not held in such trust or estate shall be treated as allowable in arriving at adjusted gross income.

## APPENDIX C

## 72 Fed. Reg. 41,423 (July 27, 2007) (Notice of Proposed Rulemaking and Notice of Public Hearing)

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

**[REG–128224–06]**

**RIN 1545–BF80**

**Section 67 Limitations on Estates or Trusts**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

---

**SUMMARY:** This document contains proposed regulations that provide guidance on which costs incurred by estates or non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a). The regulations will affect estates and non-grantor trusts. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written and electronic comments must be received by October 25, 2007. Outlines of topics to be discussed at the public hearing scheduled for November 14, 2007 must be received by October 24, 2007.

**ADDRESSES:** Send submissions to CC:PA:LPD:PR (REG-128224-06), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-128224-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (indicate IRS and REG-128224-06). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Jennifer N. Keeney, (202) 622-3060; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard A. Hurst, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to 26 CFR part 1. Section 67(a) of the Internal Revenue Code (Code) provides that, for an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 67(b) excludes certain itemized deductions from the definition of "miscellaneous itemized deductions." Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual. However, section 67(e)(1) provides that the deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust shall be treated as allowable in arriving at adjusted gross income. Therefore, deductions described in section 67(e)(1) are not subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a).

United States courts of appeals have interpreted the language of section 67(e)(1) differently in determining whether costs incurred by trustees are subject to the 2-percent floor. The issue in each case has been whether the trust's costs (specifically, investment advisory fees) "would not have been incurred if the property were not held in such trust or estate." In *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), the Court of Appeals for the Sixth Circuit held that investment advisory fees paid for professional investment services were fully deductible under section 67(e)(1) where the trustees lacked experience in managing large sums of money. The court found that, under state law, the trustee was required to engage an investment advisor to meet its fiduciary obligations and to incur fees that the trust would not have incurred if the property were not held in trust. The court held that estate or trust expenditures that are necessary to meet specific fiduciary obligations under state law are not subject to the 2-percent floor. In contrast, in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), and *Rudkin v. Commissioner*, 467 F.3d 149 (2d Cir. 2006), the courts held that investment advisory fees are subject to the 2-percent floor. These courts read the language of section 67(e)(1) differently than the Sixth Circuit. Specifically, the courts in *Scott* and *Mellon Bank* concluded that a trust expense is subject to the 2-percent floor if it is an expense "commonly" or "customarily" incurred by individuals; and the court in *Rudkin* looked to whether such an expense was "peculiar to trusts" and "could not" be incurred by an individual.

The result of this lack of consistency in the case law is that the deductions of similarly situated taxpayers may or may not be subject to the 2-percent floor, depending upon the jurisdiction in which the executor or the trustee is located. The IRS and the Treasury Department believe that similarly situated taxpayers should be treated consistently by having

section 67(e)(1) construed and applied in the same way in all jurisdictions. The proposed regulations are intended to provide a uniform standard for identifying the types of costs that are not subject to the 2-percent floor under section 67(e)(1).

**Explanation of Provisions**

These proposed regulations provide that costs incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the 2-percent floor. For this purpose, a cost is unique to an estate or trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. To the extent that expenses paid or incurred by an estate or non-grantor trust do not meet this standard, they are subject to the 2-percent floor of section 67(a). (Neither section 67 nor this rule applies to expenses that are excluded under section 67(b) from the definition of miscellaneous itemized deductions, or to expenses related to a trade or business.)

Under the proposed regulations, whether costs are subject to the 2- percent floor on miscellaneous itemized deductions depends on the type of services provided, rather than on taxpayer characterizations or labels for such services. Thus, taxpayers may not circumvent the 2-percent floor by "bundling" investment advisory fees and trustees' fees into a single fee. The regulations provide that, if an estate or non-grantor trust pays a single fee that includes both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must use a reasonable method to allocate the single fee between the two types of costs. The regulations also provide a non-exclusive list of services for which the cost is either exempt from or subject to the 2-percent floor. The IRS and the Treasury Department invite comments on whether any safe harbors or other guidance, concerning allocation methods or otherwise, would be helpful.

**Proposed Effective Date**

The regulations, as proposed, apply to payments made after the date final regulations are published in the **Federal Register.**

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the proposed rules, as well as their clarity and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 14, 2007, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter

the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 24, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these regulations is Jennifer N. Keeney, Office of the Office of Associate Chief Counsel (Passthroughs and Special Industries).

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

**Par. 2.** Section 1.67-4 is added to read as follows:

§ 1.67-4 Costs paid or incurred by estates or non-grantor trusts.

(a) *In general.* Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust not described in § 1.67-2T(g)(1)(i) (a non-grantor trust) and which would not have been incurred if the property were not held in such estate or trust. To the extent that a cost incurred by an estate or non-grantor trust is unique to such an entity, that cost is not subject to the 2-percent floor on miscellaneous itemized deductions. To the extent that a cost included in the definition of miscellaneous itemized deductions and incurred by an estate or non-grantor trust is not unique to such an entity, that cost is subject to the 2-percent floor.

(b) *Unique.* For purposes of this section, a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant. A non-exclusive list of products or services that are unique to an estate or trust includes those rendered in connection with: Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters. A non-exclusive list of products or services that are not unique to an estate or trust, and therefore are subject to the 2-percent floor, includes those rendered in connection with: Custody or management of property; advice on investing for total return;

gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

(c) *"Bundled fees."* If an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

(d) *Effective/applicability date.* These regulations are proposed to be effective for payments made after the date final regulations are published in the **Federal Register**.

**Kevin M. Brown,**

*Deputy Commissioner for Services and Enforcement.*

[FR Doc. E7-14489 Filed 7-26-07; 8:45 am]

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No. 06-1286

# In the Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT

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## QUESTION PRESENTED

Whether investment-advice fees incurred by petitioner, a trust, are costs "which would not have been incurred if the property were not held in such trust" within the meaning of 26 U.S.C. 67(e)(1).

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# In the Supreme Court of the United States

No. 06-1286

MICHAEL J. KNIGHT, TRUSTEE OF THE
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PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI*
*TO THE UNITED STATES COURT OF APPEALS*
*FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT

### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 467 F.3d 149. The opinion of the Tax Court (Pet. App. 20a-30a) is reported at 124 T.C. 304.

### JURISDICTION

The judgment of the court of appeals was entered on October 18, 2006. A petition for rehearing was denied on January 19, 2007 (Pet. App. 31a-32a). The petition for a writ of certiorari was filed on March 23, 2007, and was granted on June 25, 2007. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## STATUTORY PROVISIONS INVOLVED

The pertinent statutory provisions are set forth in an appendix to this brief. App., *infra*, 1a-5a.

## STATEMENT

1. Section 1 of the Internal Revenue Code imposes a tax on the "taxable income" of individuals and trusts. 26 U.S.C. 1 (2000 & Supp. IV 2004). The computation of taxable income begins with a determination of "gross income," which is defined as "all income from whatever source derived." 26 U.S.C. 61(a). Taxpayers can then subtract from gross income certain so-called "above-the-line" deductions, such as trade and business expenses, losses from the sale or exchange of property, and deductions attributable to rents and royalties, to arrive at "adjusted gross income." 26 U.S.C. 62(a) (2000 & Supp. IV 2004). Taxable income is calculated by subtracting from adjusted gross income "itemized," or "below-the-line," deductions, consisting of all deductions other than above-the-line deductions and the deduction for personal exemptions. 26 U.S.C. 63 (2000 & Supp. IV 2004).

In the case of individuals, 26 U.S.C. 67(b) defines a subset of itemized deductions called "miscellaneous itemized deductions," which are deductible "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income," 26 U.S.C. 67(a). That limitation was imposed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 132(a), 100 Stat. 2113, and it is often referred to as the "2% floor." Fees paid for investment advice are deductible under 26 U.S.C. 212, which allows deductions for ordinary and necessary expenses paid or incurred in producing income and in managing property held for the production of income. See 26 C.F.R. 1.212-1(g). Such fees constitute miscellaneous

itemized deductions that are subject to the 2% floor. See 26 C.F.R. 1.67-1T(a)(1)(ii).

The 2% floor applicable to individuals also applies to trusts, with limited exceptions.[1] Under 26 U.S.C. 67(e), "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate * * * shall be treated as allowable" notwithstanding the 2% floor.

2. Petitioner is a multi-generational trust that was established in 1967 under the will of Henry A. Rudkin, Sr., and was funded with proceeds from the sale of the Pepperidge Farm baked-goods company to the Campbell Soup Company. Pet. App. 21a. The beneficiaries are Henry's son, William, and William's descendants. *Id.* at 21a, 35a-36a. The will gives petitioner's fiduciaries broad powers to invest petitioner's assets, and it authorizes them to obtain outside advice in making those investments. *Id.* at 21a-22a, 38a, 41a.

During 2000, petitioner held between $2.2 million and $3.4 million in marketable securities, and it paid Warfield Associates, Inc. (Warfield), $22,241 for investment-management advice. Pet. App. 22a; J.A. 12-27. On its fiduciary income tax return for 2000, petitioner reported total income of $624,816, and it deducted, in full, the fees that it had paid to Warfield for investment advice. Pet. App. 3a, 22a-23a; J.A. 12. After an audit, the Commissioner allowed petitioner to deduct the investment-

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[1] The statute applies equally to trusts and to estates. For convenience, and because petitioner is a trust, this brief will refer solely to trusts.

advice fees only to the extent that they exceeded 2% of petitioner's adjusted gross income, resulting in a tax deficiency of $4448. Pet. App. 3a, 22a.

3. Petitioner sought review of the asserted deficiency in the Tax Court. At trial, petitioner appeared through its trustee, Michael J. Knight, a certified public accountant. Knight discussed petitioner's practices but did not testify under oath. Knight did not present any evidence regarding petitioner's investment objectives or his qualifications and ability to achieve those objectives. The record also lacks evidence about Warfield and its schedule of fees for investment-management advice. See J.A. 10-11 (stipulation of facts).

Petitioner relied on *O'Neill* v *Commissioner*, 994 F.2d 302 (1993), rev'g 98 T.C. 227 (1992), nonacq., 1994-2 C.B. 1, in which the Sixth Circuit held that investment-management fees paid by a trustee are covered by the exception in Section 67(e)(1). The *O'Neill* court reasoned that because a trustee has a fiduciary duty under state law to manage assets prudently, fees for investment advice are necessary to the trust's administration. Although individual investors can incur similar costs, "they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* at 304.

In response, the Commissioner cited *Mellon Bank, N.A.* v. *United States*, 265 F.3d 1275 (2001), aff'g 47 Fed. Cl. 186 (2000), in which the Federal Circuit rejected *O'Neill* and held that expenses are fully deductible only if they are "unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1281. Since investment advice and management fees "are commonly incurred outside of trusts," the Federal Circuit concluded, they are not covered by Section

67(e)(1) and are subject to the 2% floor. *Ibid.* The Fourth Circuit has reached a similar conclusion. See *Scott* v. *United States*, 328 F.3d 132, 140 (2003) ("Because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the 2% floor created by [Section] 67(a)."), aff'g 186 F. Supp. 2d 664 (E.D. Va. 2002).

4. The Tax Court, in a reviewed decision, unanimously upheld the deficiency. Pet. App. 20a-30a. It concluded that the construction of Section 67(e) that it had set forth in *O'Neill* v. *Commissioner*, 98 T.C. 227, 230-231 (1992), rev'd 994 F.2d 302 (6th Cir. 1993), nonacq. 1994-2 C.B. 1, "remain[ed] sound." Pet. App. 29a. The Tax Court rejected the Sixth Circuit's approach, explaining that because anything a trustee does in connection with the administration of a trust is arguably in furtherance of his or her fiduciary duty, petitioner's argument would make all administrative expenses fully deductible and would render the second clause of Section 67(e)(1) superfluous. *Id.* at 28a-29a. The Tax Court thus agreed with the Commissioner that Section 67(e)(1) allows full deductibility only for expenses that are not commonly incurred outside of the trust setting. *Id.* at 26a-29a. Because investment-advice fees are commonly incurred by individuals in managing their own investments, the Tax Court held that they are subject to the 2% floor. *Id.* at 27a, 30a.

5. The court of appeals affirmed. Pet. App. 1a-19a. The court rejected the Sixth Circuit's position on the question presented, and ultimately reached the same result as the Fourth and Federal Circuits, although on the basis of different reasoning. Consistent with the analysis of the Fourth and Federal Circuits, the court of appeals explained that "the statutory language directs

the inquiry toward the counterfactual condition of assets held individually instead of in trust," but it "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." *Id.* at 11a. Instead, "the statute sets an objective limit on the availability of a full deduction." *Id.* at 12a. "[A]s the source of that limit," the court continued, Section 67(e)(1) "looks to those costs that individual property owners are capable of incurring." *Ibid.* In the court's view, "the plain text of [Section] 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual." *Ibid.* The court therefore held "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." *Id.* at 12a-13a. Because the investment-advice fees at issue were costs that individuals could incur, those fees were held to be subject to the 2% floor even though they were incurred by a trust in the course of its administration. The court explained that its analysis differed from that of the Fourth and Federal Circuits because it did not require an inquiry into whether a given cost is "*customarily*" or "*commonly*" incurred by individuals. *Id.* at 12a.

6. On July 27, 2007, the Internal Revenue Service (IRS) issued a proposed Treasury regulation interpreting Section 67(e). See Prop. Treas. Reg. 1.67-4, 72 Fed. Reg. 41,245. The proposed regulation is consistent with the reasoning of the court of appeals and provides that a cost is not subject to the 2% floor if it is "unique" to a trust. Prop. Treas. Reg. 1.67-4(a), 72 Fed. Reg. at 41,245. A cost is "unique" to a trust "if an individual could not have incurred that cost in connection with

property not held in [a] * * * trust." Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245.

The IRS will hold a public hearing on the proposed regulation on November 14, 2007. 72 Fed. Reg. at 41,245. If the regulation is adopted as proposed, it will be prospective in effect, governing all payments made after its publication. Prop. Treas. Reg. 1.67-4(d), 72 Fed. Reg. at 41,245; see generally 26 U.S.C. 7805(b); cf. *Smiley* v. *Citibank (S.D.) N.A.*, 517 U.S. 735, 744 n.3 (1996) ("Where * * * a court is addressing transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means.").

## SUMMARY OF ARGUMENT

Under 26 U.S.C. 67(a), trusts, like individuals, may claim miscellaneous itemized deductions only to the extent that those deductions exceed 2% of adjusted gross income. Section 67(e)(1) creates a limited exception for costs that are paid "in connection with the administration of" a trust and that "would not have been incurred if the property were not held in such trust." 26 U.S.C. 67(e)(1). As this Court has repeatedly held, such exceptions to a general rule of taxability must be narrowly construed. The court of appeals correctly held that investment-advice fees do not qualify for that narrow exception.

Considered in the abstract, there are three linguistically permissible interpretations of the phrase "costs * * * which would not have been incurred if the property were not held in such trust." The phrase could be understood (1) to require an individualized assessment of the hypothetical question whether the specific individual(s) who would have been in possession of the particu-

lar property but for the existence of the trust would have incurred the specific cost at issue; (2) to encompass only those costs that definitely would not have been incurred absent a trust, *i.e.*, costs that individuals simply do not incur; or (3) to apply to those costs that individuals do not customarily or commonly incur. The first interpretation is not urged by any party, has not been adopted by any court, and must be rejected because it would be hopelessly vague, unworkable, and burdensome for trusts, the IRS, and the courts alike. There is no indication that Congress intended that wholly unworkable result. Rather, in keeping with the statutory text, the proper focus is on the nature of the cost at issue, not the (entirely speculative) particular factual circumstances of the (often unknowable) individual(s) who "would have" possessed the assets at issue in the absence of a trust.

Under either one of the remaining two linguistically permissible interpretations of the "would not have been incurred" clause, investment-advice fees are not covered by Section 67(e)(1). First, as the court of appeals here reasoned, the statute is best read to require certainty that the costs at issue would not have been incurred outside of a trust. Only costs that are unique to trusts can be confidently excluded from the expenses individuals would incur without a trust. As a result, it follows that Section 67(e)(1) does not exempt from the 2% floor any costs that could have been incurred by individuals. Petitioner errs in suggesting that the court of appeals impermissibly substituted "could" for "would" in the statute. Rather, the inquiry into expenses unique to trusts is inevitable once the focus shifts from an utterly unworkable counterfactual attempt to determine what expenses a beneficiary would have incurred if it were

not a trust, to a workable and generalized inquiry. Only if individuals by definition do not incur a particular type of cost experienced by trusts is it possible to conclude with assurance that the cost "would not have been incurred if the property were not held in such trust or estate."

Alternatively, as the Fourth and Federal Circuits have concluded, "would" may be understood to refer to what is customary or common, and thus Section 67(e) does not encompass costs that are commonly incurred by individuals. The first construction is preferable because it makes the statute significantly more administrable, but under either reading, investment-advice fees do not qualify. Individuals can—and commonly do—incur such fees with respect to assets that are held outside of a trust, and petitioner offered no evidence to the contrary.

Petitioner contends that Section 67(e) imposes a weak "causation" test under which costs that are caused in some sense by the trustee's exercise of fiduciary responsibilities are exempt from the 2% floor. But the statute's text imposes no such weak causal test. Far from examining the nature of the cost at issue from the perspective of whether it was caused by the trustee's duties, the statute instead looks to the counterfactual question of whether *individuals* would have incurred such costs in the *absence* of a trust—and prudent individuals may well incur the very same costs that a prudent trustee would be motivated to incur in furtherance of the trustee's fiduciary obligations.

Moreover, petitioner's weak causation test must be rejected because it would deprive the "would not have been incurred" clause of any effect. Petitioner's test at most captures the universe of costs subject to potential

deduction before consideration of the "would not have been incurred" clause. If the trustee is acting in good faith, all costs associated with trust administration are incurred in the exercise of the trustee's fiduciary duty, and thus all such costs would be exempt under petitioner's approach. But Section 67(e) clearly provides that deductions are exempt from the 2% floor only if they are incurred in connection with trust administration *and* would not have been incurred absent a trust. Moreover, to the extent that petitioner's rule requires identification of the causes of a particular trustee's decision to incur a particular cost, it is unworkable in practice and would result in inconsistent treatment of the same costs from trust to trust.

Finally, petitioner advances various arguments based on legislative history and policy considerations. The decision of the court of appeals is entirely consistent with the legislative history, which shows that one of Congress's goals in enacting the 2% floor was to reduce abuses, an objective that is advanced by applying the 2% floor to trust investment-advice fees. And, contrary to petitioner's suggestion, there is no reason to believe that the rule adopted by the court of appeals will lead trustees to neglect their fiduciary duty by failing to seek investment advice when such advice is needed.

## ARGUMENT

### SECTION 67(e) OF THE INTERNAL REVENUE CODE DOES NOT PERMIT A FULL DEDUCTION FOR THE COST OF INVESTMENT MANAGEMENT AND ADVISORY SERVICES PROVIDED TO TRUSTS AND ESTATES

#### A. Under 26 U.S.C. 67(e)(1), Costs Incurred By A Trust Are Exempt From The 2% Floor Only If They Are Not Costs Of A Type That Individuals Incur

##### *1. Section 67(e)(1) looks to the conduct of individuals outside the context of trusts to determine whether an expense is subject to the 2% floor*

The introductory text of 26 U.S.C. 67(e) establishes the general policy that "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual." Under that general policy, deductions for investment-advice fees—whether incurred by trusts or by individuals—are treated as miscellaneous itemized deductions subject to the 2% floor of 26 U.S.C. 67(a).[2] Section 67(e)(1) then creates a limited

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[2] Petitioner advances various arguments (Br. 26-27, 30-31) based on the treatment of trust expenses before 1986. But the 2% floor did not exist until 1986, so the different treatment of trust expenses before 1986 sheds no light on the proper interpretation of 26 U.S.C. 67. Nor is there any merit to the argument of amicus curiae the Florida Bar (Br. 6-7, 25-26) that 26 U.S.C. 212 and 26 U.S.C. 2053 (2000 & Supp. IV 2004) control the application of 26 U.S.C. 67(e). Section 212 (along with 26 C.F.R. 1.212-1(d)) is in no way a "parent statute" to Section 67(e), but instead stands for the unremarkable proposition that expenses ostensibly incurred for the production, collection, or management of income outside of a trade or business must have a proximate relation to that purpose to be deductible at all. There is no dispute that the costs of investment advice at issue here satisfy the requirements of Section 212. While Section 2053(a) (along with 26 C.F.R. 20.2053-3) allows the

exception to that general policy, allowing specified costs that qualify for the exception to be deducted in full in computing adjusted gross income.

"In construing provisions * * * in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision." *Commissioner* v. *Clark*, 489 U.S. 726, 739 (1989). That is doubly true of Section 67(e)(1), because it confers a deduction that would otherwise be unavailable. See *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) ("an income tax deduction is a matter of legislative grace and * * * the burden of clearly showing the right to the claimed deduction is on the taxpayer") (citation omitted); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."); see also *United States* v. *Centennial Sav. Bank FSB*, 499 U.S. 573, 583 (1991) (applying "the rule that tax-exemption and -deferral provisions are to be construed narrowly"). Any ambiguity in the scope of the exception created by Section 67(e)(1) must therefore be resolved in favor of the general rule that trusts are to be taxed in the same manner as individuals: "Given that Congress has enacted a general rule * * *, we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception." *Clark*, 489 U.S. at 739.

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deduction of certain administrative expenses in calculating a decedent's taxable estate subject to the *estate* tax, see 26 U.S.C. 2001 (2000 & Supp. IV 2004), that has no bearing on the unrelated *income* tax question at issue here.

Section 67(e)(1) establishes two requirements for expenditures to qualify for the exception. The first requirement is set forth in the first clause of Section 67(e)(1), which states that the costs must be those "which are paid or incurred in connection with the administration of the estate or trust." 26 U.S.C. 67(e)(1). That clause "defines the relationship between the costs and the administration of the trust," *Mellon Bank*, 265 F.3d at 1280, by separating trust-related administrative expenses from other types of expenses that a trust might incur. There is no dispute that fees for investment advice satisfy that clause.

The second requirement is set forth in the second clause of Section 67(e)(1), which provides that the costs must be those "which would not have been incurred if the property were not held in such trust or estate." 26 U.S.C. 67(e)(1). In keeping with the plain meaning of the text and the canon that statutes should be interpreted to give effect to all their terms, the second clause does not simply separate trust-related administrative costs from other types of expenses, because the first clause has already done that. Cf. *Cooper Indus., Inc.* v. *Aviall Servs., Inc.*, 543 U.S. 157, 166-167 (2004); *Duncan* v. *Walker*, 533 U.S. 167, 174 (2001). Instead, the second clause must be understood as a "filter" for determining the *subset* of trust-related administrative costs that are exempt from the 2% floor. *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281. In particular, the statute as a whole seeks to identify only those trust-related expenses that would *not* have been incurred in the counterfactual world in which no trust was created. Because in reality, a trust was created, this text provides an interpretive challenge.

Considered in the abstract, there are three linguistically permissible interpretations of the critical phrase "costs * * * which would not have been incurred if the property were not held in such trust." The phrase could be understood (1) to require an individualized assessment of the hypothetical question whether the specific individual(s) who would have been in possession of the particular property but for the existence of the trust would have incurred the specific cost at issue; (2) to encompass only those costs that definitely would not have been incurred absent a trust, *i.e.*, costs that individuals simply do not incur; or (3) to apply to those costs that individuals do not customarily or commonly incur.

The first interpretation is not urged by any party, has not been adopted by any court, and should be rejected out of hand. If Section 67(e)(1) were read to necessitate an individualized assessment of each cost incurred by each trust in light of the unique circumstances of the grantor(s) and beneficiary(ies) in an effort to predict hypothetical outcomes in the absence of a trust, it would be hopelessly vague and administratively unworkable, and would impose substantial burdens and inefficiencies on trusts, the IRS, and the courts.

As an initial matter, it is unclear how the relevant decision-maker (whether a trustee seeking to determine the deductibility of a cost, the IRS auditing a trust return, or a court attempting to resolve a dispute) would even go about determining who would have held the trust's assets if the trust did not exist. The assets might have been held by the grantor (if living) or the grantor's heirs, by some or all of the trust beneficiaries, by the trustee, or by some third party. And some of those multiple potential holders of the assets in the hypothetical no-trust world would presumably have been more likely

than others to incur the costs at issue, further complicating an already hopelessly speculative predictive effort.

On the facts of this case, for example, there is no satisfactory way to identify with accuracy the hypothetical asset-holder(s) in the counterfactual no-trust world, which would seem to be a necessary first step in making the speculative individualized prediction whether one, some, or all of such hypothetical person(s) in particular would have incurred investment-advisory fees in that counterfactual world. Nor is there any principled basis for determining precisely how such hypothetical person or persons would have acted in the hypothetical counterfactual world; all that can be determined with any confidence is that such person(s) would *not* have incurred any costs of a type that individuals do not (because they cannot) incur.

As the court of appeals observed, "[n]othing in the statute indicates that Congress intended the test for the exception to the two-percent floor to give rise to factual disputes about whether an individual asset owner (or owners) is insufficiently financially savvy or the assets sufficiently large such that he or she unquestionably would have sought investment advice." Pet. App. 11a. Making the deductibility of investment advice turn on the complexity of a trust's finances and the financial acumen of the unknown (and unknowable) person(s) who would have held the assets in the speculative no-trust world would needlessly multiply administrative and judicial proceedings by requiring a detailed analysis of each trust and its grantors, trustees, and beneficiaries (among others), and it would result in inconsistent treatment of the same costs from trust to trust.

Instead, as the court of appeals recognized, the phrase "such trust" in the second clause "is best under-

stood as referring to the generic trust of [Section] 67(e)'s introductory language and not to any actual, particular trust that incurred a cost subject to scrutiny." Pet. App. 13a. Thus, the reference to a generic trust or estate keeps the analysis focused on the type of cost at issue, not on the idiosyncracies of the trust that happened to incur it. Unlike the first clause, which is in the indicative mood, the second clause employs the subjunctive mood, and thus describes a condition that is hypothetical or contrary to fact. The second clause does not ask what in fact happened; rather, it asks whether something (namely, the incurrence of a cost) *would not* have happened if a trust had not existed. As the court of appeals explained, the clause "focuses the inquiry * * * on the hypothetical situation where the assets are in the hands of an individual." *Id.* at 11a. See *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281; Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245 ("In making this determination, it is the type of product or service rendered to the estate or trust * * * that is relevant."). Courts cannot make factual inquiries into hypothetical and counterfactual circumstances. Accordingly, the text must call for a more categorical and legal treatment of trust expenses. The statute "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." Pet. App. 11a. Section 67(e)(1) should instead be construed to mandate a generalized inquiry regarding the type of cost at issue.

### 2. *Section 67(e)(1) is best read to exempt from the 2% floor only those costs that individuals do not incur absent a trust*

Once the individualized-assessment approach is rejected as entirely impracticable, two linguistically permissible interpretations remain for consideration. Under Section 67(e)(1), only those costs paid in connection with the administration of a trust that "would not have been incurred if the property were not held in such trust" are exempted from the 2% floor imposed by 26 U.S.C. 67(a). In common parlance, the phrase "would not have" can be used either to indicate something that definitely would not have occurred, or something that would not commonly or customarily have occurred. Either definition provides the basis for a permissible reading of the statute, but the former is preferable because it makes the statute significantly easier to administer.

a. The court of appeals held that Section 67(e)(1) "permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." Pet. App. 13a. The proposed Treasury regulation would likewise limit full deductibility to costs that are "unique" to trusts and estates, explaining that "a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust." Prop. Treas. Reg. 1.67-4(a) and (b), 72 Fed. Reg. at 41,245. That position represents the best reading of the statutory text.

Petitioner contends (Br. 45) that the court of appeals and the proposed Treasury regulation err because they read "would" to mean "could," and "'[w]ould' simply does not mean 'could.'" Petitioner is mistaken. Contrary to petitioner's characterization, the court of ap-

peals (like the proposed regulation) did not simply substitute "could" for "would" in the same sentence. Instead, the court analyzed the grammar and structure of Section 67(e) and concluded that the second clause of Section 67(e)(1), which employs the phrase "would not" in conjunction with another instance of the word "not," carried essentially the same meaning as a sentence employing the word "could" without the use of the double negative. That interpretation appropriately takes account of the statutory structure and context. Cf. *National Ass'n of Home Builders* v. *Defenders of Wildlife*, 127 S. Ct. 2518, 2534 (2007); *Dolan* v. *USPS*, 546 U.S. 481, 486 (2006). Moreover, one reason that a cost would not be incurred in certain circumstances is that it could not be incurred. And since the statutory text asks whether an expense would have been incurred in a counterfactual no-trust scenario—but does not expressly specify the degree of certainty required in answering that hypothetical question—it is open to a construction that includes only those expenses that could not have been incurred.

Section 67(e) provides that trusts must compute their income in the same way as individuals, except that they can fully deduct trust-related administrative costs that would not have been incurred by individuals outside the context of trust administration. Rephrasing the exception to reflect that "would" is the past tense of "will," see *Webster's Third New International Dictionary of the English Language* 2637 (1986) (*Webster's*), trusts can fully deduct only those trust-related administrative costs that will not be incurred by individuals outside the context of trust administration. As the court of appeals explained, "the plain language of the statute requires certainty that a particular cost 'would not have been in-

curred' if the property were not held in trust." Pet. App. 11a. And the only way to be certain that trusts will not take full deductions for costs that individuals must place under the 2% floor is to limit full deductibility to those costs that individuals are incapable of incurring. See *id.* at 11a-12a.

That interpretation reflects and is confirmed by the commonsense understanding that to say something "would not" have occurred in the absence of a certain state of affairs is a categorical negation of the possibility that it would have occurred. For example, to say that a team would not have won the game if it were not for the quarterback's outstanding play is to say that the team could not have won without the quarterback. The statutory question is not (as petitioner apparently would have it) whether the cost "might not" or "probably would not" have been incurred absent a trust, or whether it is "more likely than not" that the cost would have been avoided in that circumstance. Rather, the phrase "would not have been incurred" implicitly demands certainty that the cost would not have been incurred absent a trust. Only if individuals by definition cannot incur a particular type of cost experienced by trusts—*i.e.*, the costs are unique to trusts—is it possible to conclude with assurance that the cost "would not have been incurred if the property were not held in such trust or estate."

The same conclusion follows from parsing the logical structure of the second clause. For a cost to escape the 2% floor, it must be a cost "which would not have been incurred *if* the property were not held in such trust." 26 U.S.C. 67(e) (emphasis added). Thus, the second clause explicitly has an antecedent (an "if" statement) and implicitly has a consequent (a "then" statement). Rephrasing the provision to place the antecedent and the conse-

quent in the usual order yields "if the property were not held in trust, then the cost would not have been incurred." The statement "if not A then not B" is the logical equivalent of "B only if A." Irving M. Copi & Carl Cohen, *Introduction to Logic* 357-364, 403-404 (10th ed. 1998). Thus, the reordered statutory sentence is the logical equivalent of the proposition that "the cost would be incurred only if the property is held in trust." The only costs for which that statement is always true are those that could not be incurred outside of trusts. And that brings the analysis back to the court of appeals' correct holding that "the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." Pet. App. 13a.[3]

b. Alternatively, the word "would" in Section 67(e)(1) can be understood to express "disposition or inclination" or "custom or habitual action." *Webster's* 2638. Under that approach, adopted by the Fourth and Federal Circuits, the second clause of Section 67(e)(1) treats as fully deductible only those trust-related administrative expenses that are not customary or inclined to occur outside of the context of trusts. See *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281.

Petitioner asserts (Br. 47) that this definition of "would" is "obviously" not the sense in which the word is used in the statute. But since the statute requires an

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[3] Petitioner contends (Br. 45) that this interpretation makes the first clause of Section 67(e)(1) superfluous, because the only costs that an individual could not incur are those "paid or incurred in connection with the administration of the trust." The first clause is not superfluous, however, because it removes from consideration non-administrative costs—such as losses from bad debts—so that they need not be evaluated under the second clause, thus making the statute clearer and easier to apply.

examination of the counterfactual situation in which assets are not held in trust, it is entirely reasonable to conduct that inquiry by considering the customary or natural ways in which individuals may provide for the management of assets under such circumstances. In context, that is a permissible and natural reading of the word "would."

c. As explained above, there are essentially three possible ways of identifying costs that would not have been incurred in the absence of a trust. The individualized approach founders at the necessary first step of identifying the relevant taxpayer in the non-trust world, and is in all events hopelessly unadministrable. Although either of the other two interpretations would be reasonable and consistent with the statute, the interpretation adopted by the court of appeals is the best reading of the text and offers the most administrable approach.[4] Under that interpretation, application of the 2% floor turns simply upon whether an individual could incur a particular expense. It thereby avoids needless disputes such as those petitioner seeks to raise here (Br. 48-50). For example, that interpretation makes it unnecessary to decide how to determine the relevant population in which the expense must be "common" (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria), or what fraction of that population must incur an expense before an expense is considered "common." More importantly, it eliminates any

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[4] Petitioner errs in claiming (Br. 44) that the Commissioner has "abandoned" the position embraced by the Fourth and Federal Circuits. As discussed above, both positions represent permissible interpretations of the statute. In any event, both tests will yield the same result in almost all cases. See pp. 24-28, *infra*.

need to hold a trial to determine what fraction of the population actually incurs the expense.

Because the interpretation adopted by the court of appeals is faithful to the statute and easier to administer than the standard adopted by the Fourth and Federal Circuits, the judgment of the court of appeals should be affirmed. Indeed, assuming that the standard set forth in the proposed Treasury regulation is adopted as a final regulation, that standard, being a reasonable interpretation of Section 67(e), would be upheld under the deferential review afforded to administrative interpretations of the Internal Revenue Code.[5] See *Boeing Co.* v. *United States*, 537 U.S. 437, 448 (2003); *Chevron USA Inc.* v. *NRDC*, 467 U.S. 837 (1984).[6]

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[5] As noted, the statute asks a court to determine whether an expense would have been incurred if, contrary to fact, a trust was not formed, without expressly stating the degree of confidence that a court must have that the expense would not be incurred. The best view is that an unmodified reference to an expense that would not have been incurred implicitly demands certainty that the cost would not be incurred. Congress could have made that explicit with a modifier like "definitely." The Fourth and Federal Circuit approach, by contrast, essentially adds the modifier "commonly" or "customarily" to "would not." If there is any ambiguity as to whether the statute captures expenses that definitely would not have been incurred or instead those that commonly would not have been incurred, that ambiguity should be resolved in favor of the IRS's favored approach, either through principles of deference or through application of the canons favoring narrow construction of deductions and exceptions. See p. 12, *supra*.

[6] Petitioner errs in relying (Br. 49 n.33) on *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 (1979), to argue that the proposed Treasury regulation would be entitled to a lesser standard of deference than that required under *Chevron*. Under 26 U.S.C. 7805(a), the Secretary of the Treasury has the authority to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. Regulations issued under that authority are entitled to *Chevron* deference to the same extent as regulations issued by any other federal

### B. Investment-Advice Fees Are Subject To The 2% Floor Because They Can Be—And Commonly Are—Incurred By Individuals

As discussed, Section 67(e)(1) can reasonably be interpreted in two slightly different ways, each of which establishes an objective test that focuses on the nature of a trust-related administrative cost when deciding whether it is subject to the 2% floor. While the court of appeals' test—like that embraced by the IRS in the proposed Treasury regulation—is somewhat "more restrictive" (Pet. App. 12a) than the test adopted by the Fourth and Federal Circuits, both tests produce the same result when applied to typical trust expenses.

1. There is no dispute that costs paid or incurred for fiduciary accountings, judicial filings required as part of trust administration, the preparation and filing of fiduciary income tax returns, trust construction proceedings, fiduciary bond premiums, or communications with beneficiaries would all escape the 2% floor. All of those expenses are unique to trust administration; they are expenses that individuals cannot incur. See Pet. App. 12a; *Scott*, 328 F.3d at 140; Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245.[7]

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agency. See *United States* v. *Boyle*, 469 U.S. 241, 246 n.4 (1985); see also *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001) (regulations are entitled to *Chevron* deference if issued under an agency's "generally conferred authority * * * to speak with the force of law"); *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 980 (2005) (applying *Chevron* to regulations issued by the FCC under its authority "to 'execute and enforce' the Communications Act and to 'prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions' of the Act") (quoting Communications Act of 1934, 47 U.S.C. 151, 201(b)).

[7] The proposed regulation would require the unbundling of unitary fees so that only costs unique to estates and trusts escape the 2% floor.

2. Investment-advice fees are different. Unlike the costs illustrated above, which are unique to trust administration, the cost of third-party investment advice can be and often is incurred by individuals in managing their own affairs outside the context of trust administration. As the court of appeals noted, the fact that investment-advice fees are subject to the 2% floor under 26 C.F.R. 1.67-1T(a)(1)(ii) (a regulation applicable to individuals) demonstrates that individuals are capable of incurring those fees. Pet. App. 12a. The proposed Treasury regulation also lists other products and services that are subject to the 2% floor, including the costs associated with the custody or management of property, gift tax returns, the defense of creditor claims, and the purchase, sale, maintenance, repair, insurance, or management of non-business property. Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245. All the items on that list are costs that individuals can, and commonly do, incur.[8]

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Prop. Treas. Reg. 1.67-4(c), 72 Fed. Reg. at 41,245. The proposed regulation would categorize the most common trust expenses as falling above or below the floor, and a taxpayer could use "any reasonable method" to make the necessary allocation. *Ibid.* The IRS, moreover, has "invite[d] comments on whether any safe harbors or other guidance, concerning allocation methods or otherwise, would be helpful." 72 Fed. Reg. at 41,244. Thus, petitioner is mistaken in contending (Br. 40-41) that the test established by the proposed regulation would result in the placement of all trust expenses below the floor, or (Br. 46) that the requisite unbundling would impose an "insurmountable" administrative hurdle. Likewise, petitioner is incorrect when it contends (Br. 44 n.32) that "trustee fees" are per se deductible, "even though they primarily purchase investment management services." The proposed regulation does not specifically address trustee fees, and they would be subject to its general unbundling requirement.

[8] Petitioner asserts (Br. 42) that the current version of Form 1041, the income tax return for trusts and estates, indicates that attorney and accountant fees are fully deductible. Depending on the nature of those

Petitioner errs in arguing that the proposed Treasury regulation allows the deduction of costs for some types of investment advice. According to petitioner (Br. 42 n.30), "the Commissioner's latest proposal is that only fees for 'advice on investing for total return,' are subject to the two-percent floor." That is a misreading of the proposed regulation. The treatment of trust costs under the proposed regulation turns on whether an individual could have incurred the cost in connection with property not held in trust. See Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245. Advice on "investing for total return" is one example in the list of items subject to the 2% floor, but that list is expressly described as "non-exclusive." *Ibid.* Notably, no form of investment advice appears on the list of products or services that escape the floor. Of course, if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts, that would be a charge that an individual account holder could not have incurred, and a trust would be entitled to unbundle that "unique" charge and take a full deduction for it. See Prop. Treas. Reg. 1.67-4(c), 72 Fed. Reg. at 41,245.

Petitioner contends (Br. 42) that the decision below and the proposed Treasury regulation employ an "inappropriately broad level of generality" to describe investment-advice fees, while "more narrowly" describing costs that are not subject to the 2% floor. Described at the broadest possible level of generality, all expenses would be incurred by individuals and therefore would be subject to the 2% floor. Conversely, if trust expenses are viewed through the narrowest possible lens as hav-

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fees, they may well be deductible under the regulation. Once the proposed regulation has become final, the IRS will presumably modify the form as appropriate to reflect the provisions of the regulation.

ing been "caused" by the existence of the trust (as petitioner would have it), then none of those expenses would have been incurred by individuals (who by definition do not incur expenses for trust administration). Neither approach constitutes a sensible application of a statute that is meant to exempt some, but not all, expenses from the 2% floor. Contrary to petitioner's suggestion, the test adopted by the court of appeals—and reflected in the proposed regulation—calls for a reasonable, commonsense characterization of the expenses.

Petitioner's objection to the characterization of investment advice rests on the premise (Br. 3, 22-23) that investment advice sought by trustees is always "different in kind" from the similar advice sought by individuals, and for that reason should be subject to a different rule. That premise is incorrect. Under the prudent-investor standard, a trustee, in attempting to accomplish the goals of the trust, must act "as a prudent investor would" in attempting to accomplish the same goals. Restatement (Third) of Trusts (Prudent Investor Rule) § 227, at 8 (1992); see Uniform Prudent Investor Act § 2(a), 7B U.L.A. 20 (2006) ("A trustee shall invest and manage trust assets as a prudent investor would."); Conn. Gen. Stat. Ann. § 45a-541b(a) (West 2004). Prudent individuals can and often do seek professional assistance when making investment decisions, especially if they have substantial assets or seek to accomplish difficult financial goals. In fact, a wealthy, demanding individual with complex financial goals may well have a much greater need for professional investment advice than a small trust with simple financial goals.

Petitioner asserts (Br. 8-10, 18) that trusts may have investment objectives that differ from those of many individuals. For example, a trustee may be required to

balance the needs of income beneficiaries and principal beneficiaries. But individuals commonly face similar investment choices, and are forced to made tradeoffs between income generation and growth of capital in determining how to invest their assets. See, *e.g.*, Geoffrey A. Hirt et al., *Investment Planning for Financial Professionals* 137 (2006) (distinguishing between investment strategies intended to "generate an immediate and ongoing flow of cash" and those "with the objective of capital appreciation"). Individuals may well seek investment advice to help them balance those tradeoffs. Moreover, even if the *content* of the advice obtained by a particular trust might differ from the content of the advice that would be provided to a particular individual, that does not mean that the *fees* for the advice are somehow different in kind from the fees that would be paid by an individual. Any competent investment advisor will tailor the content of his or her advice to the unique needs of each individual or institutional client. See James W. Bronson et al., *Managing Individual Investor Portfolios, in Managing Investment Portfolios: A Dynamic Process* 20, 20 (John L. Maginn et al. eds., 2007) (noting that "[i]ndividual investors have diverse investment objectives, time horizons, and perceptions of risk"). But the fees paid for all such advice are appropriately categorized in the same manner for tax purposes. Because an individual can obtain the same kind of advice as a trust, and can pay for it in the same way, the fees for that advice cannot be characterized as an expense that would not have been incurred if the property were not held in trust.

3. Petitioner further argues (Br. 48-50) that it should prevail under the interpretation adopted by the Fourth and Federal Circuits because individuals do not com-

monly pay for investment advice. But every court that has considered that factual question in construing Section 67(e) has either recognized that individuals commonly incur costs for outside investment advice or stated that it would be prudent for them to do so. See Pet. App. 27a-28a; *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281; *O'Neill*, 994 F.2d at 304. Indeed, this Court has described the "cost of investment counsel or of investment services" as an example of "typically ordinary expenses" for an individual or an institutional asset manager. *Deputy* v. *DuPont*, 308 U.S. 488, 496-497 (1940). And even amicus curiae American Bankers Association acknowledges in its brief (Br. 6) that "individual investors often seek professional investment advice."

In any event, petitioner is in no position to make its factual argument. With exceptions not relevant here, the taxpayer bears the burden of proof on factual issues in the Tax Court. See Tax Ct. R. 142(a); *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); but cf. 26 U.S.C. 7491. In the proceeding below, petitioner acknowledged the standard employed by the Fourth and Federal Circuits, but presented no evidence to support its assertion that individuals do not commonly pay for investment advice. Thus, even under the interpretation adopted by the Fourth and Federal Circuits, petitioner cannot prevail on this record.

### C. Petitioner's Weak Causation Test Is Inconsistent With The Text Of Section 67(e)(1)

Petitioner contends (Br. 22) that the statute requires an inquiry into whether an expense was "caused by the fact that the property was held in the trust." According to petitioner, investment advice fees are "caused" by the fact that property is in trust, because they are "incurred in fulfillment of the trustee's fiduciary obligation," re-

gardless of whether they would have been incurred in the absence of a trust. *Ibid.* Petitioner's proposed test is inconsistent with the statute, and it would be unworkable in practice.

Petitioner's interpretation of Section 67(e)(1) is essentially the same as that set forth by the Sixth Circuit in *O'Neill* v. *Commissioner*, *supra*; see Action on Decision, No. CC-1994-06, 1994 WL 805239 (IRS Sept. 12, 1994) (expressing the IRS's disagreement with, and nonacquiescence in, the Sixth Circuit's interpretation). The court in *O'Neill* concluded that the investment-advice fees were incurred "because the property was held in trust." 994 F.2d at 304. The court stated that a trustee has a duty to manage trust assets under a prudent-investor standard, and that professional assistance may be warranted if he or she lacks experience in investing large sums of money. *Ibid.* The fees for that advice were therefore "necessary to the continued growth" of the trust and "caused by the fiduciary duties" of the trustees. *Ibid.*

There is no support, however, either in the words of Section 67(e)(1) or in the grammatical context in which those words are used, for the conclusion that full deductibility turns on whether a trustee was fulfilling a fiduciary duty when he or she incurred a particular cost. In the first place, the statute does not mandate a factual inquiry into whether the expense flows from the trust. Rather, it mandates a counterfactual inquiry into whether the expense would not have been incurred in the absence of a trust. Moreover, petitioner's proposed construction would read the critical words right out of the statute. A requirement that expenses be related to the discharge of fiduciary duties is what the first clause of Section 67(e)(1) demands, because it requires a con-

nection between the cost incurred and trust administration. The second clause of Section 67(e)(1) does not redundantly ask whether a trustee merely incurred a cost in the exercise of his or her fiduciary duty, but instead asks whether the trust was the sole cause of the expense, *i.e.*, whether the expense "would not have been incurred" in the absence of the trust. A weak causal connection between the trustee's fiduciary obligation and the cost is not enough to escape the 2% floor; instead, only expenses uniquely connected to the trust—those that would not have been incurred absent a trust—escape the floor. Prudent individuals acting to protect their own interests will often incur the very same costs that a trustee would be motivated to incur in fulfillment of his or her fiduciary obligations, so a focus on costs causally linked to those obligations simply ignores the statutory text. See *Mellon Bank*, 265 F.3d at 1280 ("Words such as 'legal obligations,' 'trustee fees,' and 'fiduciary responsibility' are not found within section 67(e)(1).").[9]

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[9] Petitioner's weak causation test also must be rejected because it improperly changes the subjunctive mood of the second clause to the indicative mood. See *Sutton* v. *United Air Lines, Inc.*, 527 U.S. 471, 482 (1999); *United States* v. *Wilson*, 503 U.S. 329, 333 (1992) ("Congress' use of a verb tense is significant in construing statutes."). The second clause of Section 67(e)(1) does not ask why a trustee incurred a cost or whether a cost was "incurred because the property was held in trust." *O'Neill*, 994 F.2d at 304; see Pet. Br. 22. Instead, it asks whether the cost was one "which would *not* have been incurred *if* the property *were not* held in such trust." 26 U.S.C. 67(e)(1) (emphases added). See *Scott*, 328 F.3d at 140 ("[T]he second [clause] of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred *outside* the administration of trusts."). The second clause requires more than a weak causal connection. Only expenses that would not have been incurred absent the trust escape the 2% floor.

Moreover, so long as trustees are acting in good faith, they are always fulfilling their fiduciary duty when they incur expenses in connection with the administration of a trust. Thus, under petitioner's test, all expenses incurred by a trustee in connection with the administration of a trust would be fully deductible. That result, however, would reduce the second clause of Section 67(e)(1) to surplusage. *Scott*, 328 F.3d at 140 ("[W]e would, by holding that a trust's investment-advice fees were fully deductible, render meaningless the second requirement of § 67(e)(1). All trust-related administrative expenses could be attributed to a trustee's fiduciary duties, and the broad reading of § 67(e)(1) urged by the taxpayers would treat as fully deductible any costs associated with a trust.").

According to petitioner (Br. 22-23), its proposed test would not allow all administrative costs to escape the 2% floor. Petitioner offers the cost of routine maintenance of real property as an example of a cost that, it claims, would be subject to the floor even under its test. Br. 23. While the cost of routine maintenance of real property is a valid administrative cost, it is nevertheless "caused" by actions taken by the trustee in furtherance of his or her fiduciary duties. On petitioner's theory, a trustee who incurred expenses to maintain real property held in a trust would be discharging the fiduciary duty to preserve trust assets. See Restatement (Second) of Trusts § 176, at 381 (1959) ("The trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property."). The expense of maintenance would thus escape the 2% floor under petitioner's rule.[10]

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[10] Amicus curiae the Florida Bar suggests (Br. 26-27) that bad debts and costs passed down from pass-through entities are examples of costs that would be subject to the 2% floor under petitioner's test. The loss

Petitioner contends (Br. 38-39) that its interpretation is supported by the principle that ambiguities in tax statutes must be construed against the government. But that supposed canon has not been employed by this Court in decades, and it is inconsistent with modern principles of statutory construction and administrative deference. And even if it might have some vestigial force in limited circumstances, it would have no application here: under principles of statutory construction that this Court *has* reaffirmed in recent decades, Section 67(e)(1) must be given a narrow construction, both because it creates an exception to the general statutory policy of Section 67(e) and because tax deductions are a matter of legislative grace. See p. 12, *supra*. Section 67 establishes the terms under which certain miscellaneous expenses can be deducted, and it should be read in its entirety in accordance with those long-standing principles. Petitioner errs in suggesting that a statutory exception authorizing a broader deduction than would otherwise be available should be interpreted as if it were a statute imposing a tax.

### D. Legislative History Furnishes Additional Support For The Decision Of The Court Of Appeals

#### *1. Subjecting investment-advice fees to the 2% floor is consistent with Congress's goals in enacting the 1986 reforms*

Because the application of Section 67(e)(1) to investment-advice fees is clear, it is not necessary to refer to legislative history. See *Department of Hous. & Urban*

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suffered from a bad debt, however, is not a cost incurred "in connection with the administration of [a] trust." And costs passed down from pass-through entities are "caused" by the trustee's decision to invest in (or to retain the trust's investments in) those entities.

*Dev.* v. *Rucker*, 535 U.S. 125, 132 (2002). In any event, the legislative history is fully consistent with the statutory text. Although there is no meaningful discussion of Section 67(e)(1) itself in the legislative history, an examination of the broader history of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, demonstrates that subjecting investment-advice fees to the 2% floor is consistent with the intent of Congress underlying the 1986 reforms.

In enacting the Tax Reform Act of 1986, Congress sought to increase the fairness, simplicity, and economic efficiency of the tax system. It believed that closing loopholes and lowering marginal rates would simplify the Code, ensure that similarly situated individuals pay similar amounts of tax, and make economically inefficient tax-avoidance schemes less attractive. H.R. Rep. No. 426, 99th Cong., 1st Sess. 54-61 (1985) (*1985 House Rep.*); see S. Rep. No. 313, 99th Cong., 2d Sess. 3-8 (1986) (*1986 Senate Rep.*). Congress refused, however, to place simplicity ahead of fairness and accuracy, recognizing that complexity was sometimes necessary to prevent sophisticated taxpayers from unfairly reducing their taxes. *1986 Senate Rep.* 4; see *1985 House Rep.* 58. Those goals are reflected in the 2% floor of Section 67(a) and in amendments to other Code sections governing the taxation of trusts.

The 2% floor was part of Congress's simplification efforts. Congress believed that the prior-law treatment of miscellaneous itemized deductions caused significant complexity because it required extensive taxpayer recordkeeping and IRS auditing for relatively small deductions. The 2% floor, Congress believed, would relieve taxpayers of the burden of recordkeeping unless they expected miscellaneous expenditures in excess of

that threshold. *1985 House Rep.* 109-110; *1986 Senate Rep.* 78-79.

Petitioner suggests (Br. 24-25, 32-33) that Congress's objective in enacting Section 67 was to limit deductions for personal expenses. Although that was one aim of the statute, it was not Congress' only goal. Rather, the Senate Finance Committee stated that "allowance of [miscellaneous itemized] deductions under present law fosters significant complexity," that "*some* of these expenses have characteristics of voluntary personal expenditures," and that "*some* miscellaneous expenses allowable under present law are sufficiently personal in nature that they would have been incurred apart from any business or investment activities of the taxpayer." *1986 Senate Rep.* 78-79 (emphasis added). Consistent with Congress's broader goals, Section 67(b) does not exclude from the 2% floor—and 26 C.F.R. 1.67-1T(a) explicitly makes subject to the floor—expenses that are directly related to earning, investing, managing, and reporting income, including continuing education, professional uniforms, investment advice, and tax advice. Those expenses are not personal in nature.

Congress also recognized that "[t]he present rules relating to the taxation of trusts and estates permit the reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or grantor of the trust or estate." *1986 Senate Rep.* 867. Congress sought to reduce the tax benefit of placing assets in trust in order to split income between a trust and its beneficiaries, primarily by setting the tax rates for trusts so that little income could be sheltered at the lower rates. See 26 U.S.C. 1(e); *1986 Senate Rep.* 868. Contrary to petitioner's argument (Br. 36-37), making the 2% floor for miscellaneous itemized deductions ap-

plicable to trusts (with an exception for trust-related administrative expenses that would not have been incurred if the property were not held in trust) advances that goal because it prevents trusts from fully deducting the same expenses that individuals cannot fully deduct. See *Scott*, 328 F.3d at 138-140; *Mellon Bank*, 265 F.3d at 1281. Moreover, treating items like the expense of investment advisors the same for individuals and trusts —*i.e.*, equally subject to the 2% floor—avoids creating artificial tax-related incentives to form trusts. In particular, it eliminates the ability of an individual to obtain full deductibility for investment advice simply by placing assets in a trust.[11]

***2. An examination of the bills culminating in the enactment of 26 U.S.C. 67(e) refutes petitioner's argument that the provision was intended to apply only to expenses incurred by trusts from pass-through entities***

Based on committee materials and the bills leading up to the present version of 26 U.S.C. 67(e), petitioner argues (Br. 33-36) that the second clause of Section 67(e)(1) was intended by Congress only to prevent trusts from fully deducting expenses passed down to them from so-called "pass-through entities." Even if that were true, it would not justify ignoring the statutory text, which sweeps more broadly. See *Oncale* v. *Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998) ("[S]tatutory prohibitions often go beyond the principal

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[11] Petitioner errs in describing (Br. 37) Senate Report No. 313 as "inapposite." The report demonstrates that the provisions relating to trusts in the Tax Reform Act of 1986 were motivated in part by Congress's general interest in "eliminat[ing] or significantly reduc[ing]" the "tax benefits which result from the ability to split income between a trust or estate and its beneficiaries," *1986 Senate Rep.* 868, an interest that is promoted by applying the 2% floor to trusts.

evil to cover reasonably comparable evils, and it is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed."). In any event, petitioner's interpretation of the legislative history is incorrect.

Pass-through entities generally consist of partnerships, grantor trusts, nonpublic mutual funds, and corporations that elect to be taxed under Subchapter S of the Code. See 26 C.F.R. 1.67-2T(a). Those organizations do not pay income taxes at the entity level. Instead, they pass their income down to ultimate taxpayers, usually individuals, who report that income on their individual returns and take it into consideration in calculating their income taxes. See 26 C.F.R. 1.67-2T.

Estates and ordinary trusts, like petitioner, must pay taxes on their income. See 26 U.S.C. 1(e). That income can come from a variety of sources, including investments in pass-through entities. In calculating their taxable income, however, trusts and estates generally can deduct the income that they distribute to their beneficiaries. See 26 U.S.C. 651, 661. Thus, trusts and estates are ultimate taxpayers that in some ways function like pass-through entities.

In the original House bill, 26 U.S.C. 67 imposed a floor on miscellaneous itemized deductions for individuals while allowing trusts and estates, as ultimate taxpayers, to deduct all of their administrative costs. H.R. 3838, 99th Cong., 1st Sess. § 132 (1985). The concern then arose that individuals could use pass-through entities to avoid the 2% floor. See *Issues Relating to Pass-through Entities: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. 1-3 (1986). Without some restriction on pass-through entities, an individual

could deduct the full cost of investment advice by placing his or her investments in a pass-through entity, deducting the cost of the advice at the entity level in calculating the net investment income subject to pass-through treatment, and reporting only the net investment income on his or her individual return.

To address that problem, Congress enacted 26 U.S.C. 67(c), which directs the Secretary of the Treasury to adopt regulations prohibiting "the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual."[12] Under 26 C.F.R. 1.67-2T, which implements Section 67(c), pass-through entities must separately pass down income and expense items characterized in such a way that the ultimate taxpayer knows which expenses must be placed under the floor. Congress has exempted from those reporting requirements certain pass-through entities that pose little risk of abuse, including trusts and estates when they function like pass-through entities. 26 U.S.C. 67(c)(3).

Congress's decision to add Section 67(c), however, created problems with the taxation of trusts and estates as ultimate taxpayers. If a trust were allowed to deduct all of its administrative costs, then it, unlike an individual, could fully deduct the cost of investment advice passed down to it from pass-through entities in which the trust had invested. That result was avoided by the addition of the second clause of 26 U.S.C. 67(e)(1), which limits the exemption from the 2% floor to costs "which

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[12] Petitioner relies (Br. 35) on a Conference Report that, it says, explains "the second prong of § 67(e)." But the relevant portions of the report—which refer to the promulgation of regulations addressing pass-through entities—relate to Section 67(c), not to Section 67(e). See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 34 (1986).

would not have been incurred if the property were not held in such trust or estate."

From that history, petitioner infers that the second clause of Section 67(e)(1) should be limited to restricting the deductibility of costs passed to a trust by a pass-through entity. That interpretation is difficult to reconcile with petitioner's own reading of the statutory text: according to petitioner (Br. 23), its test would subject to the 2% floor some costs that are not associated with pass-through entities. In any event, as the court of appeals observed, "[i]f Congress's only purpose had been to restrict the ability of trusts as ultimate taxpayers to deduct fully their share of the administrative costs of pass-through entities in which they had invested," it could easily have drafted Section 67(e)(1) to achieve that result. Pet. App. 18a. For example, it could simply have provided for full deductibility of administrative costs "which are not pass-through costs restricted under section 67(c)." *Ibid.* Congress did not do so, and the broader language that it employed must be given effect.

Limiting the reach of the second clause of Section 67(e)(1) to pass-through items would also create tax avoidance opportunities similar to those that Section 67(c) was designed to eliminate. Just as Section 67(c) prevents individuals from placing assets in pass-through entities to obtain full deductibility for the cost of investment advice, the court of appeals' interpretation of the second clause of Section 67(e)(1) prevents trusts, as ultimate taxpayers, from pulling assets out of pass-through entities to obtain full deductibility for the cost of investment advice—quite possibly the same advice from the same advisors as before the transfer.

**E. Petitioner's Policy Arguments Lack Merit**

Finally, petitioner argues (Br. 40-41) that subjecting investment-advice fees to the 2% floor will harm the beneficiaries of trusts. Insofar as petitioner complains that the rule adopted by the court of appeals will "erode trust corpus," that is an objection that could be leveled against any tax on trusts. All taxes reduce the assets of those who are taxed.

Petitioner also suggests that the application of the 2% floor will cause trustees to eschew professional advice in an effort to reduce their trusts' tax liabilities. That is highly unlikely, as petitioner itself demonstrates. During the year 2000, petitioner held assets exceeding $2.2 million, and its adjusted gross income was $613,263. Pet. App. 22a-23a; J.A. 24-27. It paid $22,241 (1.0% of its assets and 3.6% of its income) for investment advice, and its failure to subject its deduction for that advice to the 2% floor resulted in a deficiency of only $4448 (0.2% of its assets and 0.7% of its income). Pet. App. 22a-23a. Even if a trust is in the highest income tax bracket (currently 35%, see 26 U.S.C. 1(e); 26 U.S.C. 1(i)(2) (Supp. IV 2004)), the additional tax caused by the application of the 2% floor will be, at most, 0.7% of the trust's income. No responsible trustee would risk breaching his or her fiduciary duty by refraining from seeking investment advice merely to save such a small amount of tax.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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## APPENDIX

1. 26 U.S.C. 67 provides:

**2-percent floor on miscellaneous itemized deductions**

**(a) General rule**

In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

**(b) Miscellaneous itemized deductions**

For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than—

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

**(c) Disallowance of indirect deduction through pass-thru entity**

**(1) In general**

The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection.

**(2) Treatment of publicly offered regulated investment companies**

**(A) In general**

Paragraph (1) shall not apply with respect to any publicly offered regulated investment company.

**(B) Publicly offered regulated investment companies**

For purposes of this subsection—

**(i) In general**

The term "publicly offered regulated investment company" means a regulated investment company the shares of which are—

(I) continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(II) regularly traded on an established securities market, or

(III) held by or for no fewer than 500 persons at all times during the taxable year.

**(ii) Secretary may reduce 500 person requirement**

The Secretary may by regulation decrease the minimum shareholder requirement of clause (i)(III) in the case of regulated investment companies which experience a loss of shareholders through net redemptions of their shares.

**(3) Treatment of certain other entities**

Paragraph (1) shall not apply—

(A) with respect to cooperatives and real estate investment trusts, and

(B) except as provided in regulations, with respect to estates and trusts.

**(d) Impairment-related work expenses**

For purposes of this section, the term "impairment-related work expenses" means expenses—

(1) of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and

(2) with respect to which a deduction is allowable under section 162 (determined without regard to this section).

**(e) Determination of adjusted gross income in case of estates and trusts**

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—

(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and

(2) the deductions allowable under sections 642(b), 651, and 661,

shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

**(f) Coordination with other limitation**

This section shall be applied before the application of the dollar limitation of the second sentence of section 162(a) (relating to trade or business expenses).

2. 26 U.S.C. 212 provides:

**Expenses for production of income**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

3. 72 Fed. Reg. 41,243-41,245 (2007) provides:

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

**[REG-128224-06]**

**RIN 1545-BF80**

**Section 67 Limitations on Estates or Trusts**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

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**SUMMARY:** This document contains proposed regulations that provide guidance on which costs incurred by estates or non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a). The regulations will affect estates and non-grantor trusts. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written and electronic comments must be received by October 25, 2007. Outlines of topics to be discussed at the public hearing scheduled for November 14, 2007 must be received by October 24, 2007.

**ADDRESSES:** Send submissions to CC:PA:LPD:PR (REG-128224-06), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-128224-06), Courier's Desk,

Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (indicate IRS and REG-128224-06). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Jennifer N. Keeney, (202) 622-3060; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard A. Hurst, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to 26 CFR part 1. Section 67(a) of the Internal Revenue Code (Code) provides that, for an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 67(b) excludes certain itemized deductions from the definition of "miscellaneous itemized deductions." Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual. However, section 67(e)(1) provides that the deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust shall be treated as allowable in arriving at adjusted gross income. Therefore, deduc-

tions described in section 67(e)(1) are not subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a).

United States courts of appeals have interpreted the language of section 67(e)(1) differently in determining whether costs incurred by trustees are subject to the 2-percent floor. The issue in each case has been whether the trust's costs (specifically, investment advisory fees) "would not have been incurred if the property were not held in such trust or estate." In O'Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993), the Court of Appeals for the Sixth Circuit held that investment advisory fees paid for professional investment services were fully deductible under section 67(e)(1) where the trustees lacked experience in managing large sums of money. The court found that, under state law, the trustee was required to engage an investment advisor to meet its fiduciary obligations and to incur fees that the trust would not have incurred if the property were not held in trust. The court held that estate or trust expenditures that are necessary to meet specific fiduciary obligations under state law are not subject to the 2-percent floor. In contrast, in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), and *Rudkin v. Commissioner*, 467 F.3d 149 (2d Cir. 2006), the courts held that investment advisory fees are subject to the 2-percent floor. These courts read the language of section 67(e)(1) differently than the Sixth Circuit. Specifically, the courts in *Scott* and *Mellon Bank* concluded that a trust expense is subject to the 2-percent floor if it is an expense "commonly" or "customarily" incurred by individuals; and the court in *Rudkin* looked to whether

such an expense was "peculiar to trusts" and "could not" be incurred by an individual.

The result of this lack of consistency in the case law is that the deductions of similarly situated taxpayers may or may not be subject to the 2-percent floor, depending upon the jurisdiction in which the executor or the trustee is located. The IRS and the Treasury Department believe that similarly situated taxpayers should be treated consistently by having section 67(e)(1) construed and applied in the same way in all jurisdictions. The proposed regulations are intended to provide a uniform standard for identifying the types of costs that are not subject to the 2-percent floor under section 67(e)(1).

**Explanation of Provisions**

These proposed regulations provide that costs incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the 2- percent floor. For this purpose, a cost is unique to an estate or trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. To the extent that expenses paid or incurred by an estate or non-grantor trust do not meet this standard, they are subject to the 2-percent floor of section 67(a). (Neither section 67 nor this rule applies to expenses that are excluded under section 67(b) from the definition of miscellaneous itemized deductions, or to expenses related to a trade or business.)

Under the proposed regulations, whether costs are subject to the 2- percent floor on miscellaneous itemized deductions depends on the type of services provided, rather than on taxpayer characterizations or labels for

such services. Thus, taxpayers may not circumvent the 2-percent floor by "bundling" investment advisory fees and trustees' fees into a single fee. The regulations provide that, if an estate or non-grantor trust pays a single fee that includes both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must use a reasonable method to allocate the single fee between the two types of costs. The regulations also provide a non-exclusive list of services for which the cost is either exempt from or subject to the 2-percent floor. The IRS and the Treasury Department invite comments on whether any safe harbors or other guidance, concerning allocation methods or otherwise, would be helpful.

**Proposed Effective Date**

The regulations, as proposed, apply to payments made after the date final regulations are published in the **Federal Register**.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business

Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the proposed rules, as well as their clarity and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 14, 2007, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 24, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be pre-

pared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these regulations is Jennifer N. Keeney, Office of the Office of Associate Chief Counsel (Passthroughs and Special Industries).

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 * * *

**Par. 2.** Section 1.67-4 is added to read as follows:

**1.67-4 Costs paid or incurred by estates or non-grantor trusts.**

(a) *In general.* Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust not described in § 1.67-2T(g)(1)(i) (a non-grantor trust) and which would not have been incurred if the property were not held in such estate or trust. To the extent that a cost incurred by an estate or non-grantor trust is unique to

such an entity, that cost is not subject to the 2-percent floor on miscellaneous itemized deductions. To the extent that a cost included in the definition of miscellaneous itemized deductions and incurred by an estate or non-grantor trust is not unique to such an entity, that cost is subject to the 2-percent floor.

(b) *Unique.* For purposes of this section, a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant. A non-exclusive list of products or services that are unique to an estate or trust includes those rendered in connection with: Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters. A non-exclusive list of products or services that are not unique to an estate or trust, and therefore are subject to the 2-percent floor, includes those rendered in connection with: Custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

(c) *"Bundled Fees."* If an estate or a non-grantor trust pays a single fee, commission or other expense for

both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

(d) *Effective/applicability date.* These regulations are proposed to be effective for payments made after the date final regulations are published in the **Federal Register.**

**Kevin Brown,**

*Deputy Commissioner for Services and Enforcement.*

71 5306 (9) 52pg

No. 06-1286

IN THE

# Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

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NOVEMBER 2, 2007

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## INTRODUCTION

Petitioner has put forth a straightforward and easily administered reading of § 67(e): trust and estate investment management fees are incurred because the property is held in the trust or estate; they therefore are deductible in full. This is the only reading that is faithful to the language of § 67 and the text and structure of the Internal Revenue Code and the 1986 Act. Brief for Petitioner ("Pet. Br.") 22-31. It is the only reading consistent with the Code's net income taxation policy and with the broader income tax treatment of trusts and estates. Pet. Br. 24-28. It is confirmed, as concessions in the Commissioner's brief make clear, by the statutory history of the provision. Brief for Respondent ("Govt. Br.") 37-38; see *Powerex Corp. v. Reliant Energy Systems*, 127 S. Ct. 2411, 2416-17 (2007). And it provides the bright-line rule all agree Congress intended. Even without resort to the legislative history, which in any event supports Petitioner's position, Pet. Br. 31-37, it is thus clear that Petitioner's is the only sustainable reading of the statutory text. Nothing in the Commissioner's brief refutes this.

What the Commissioner proposes instead is yet another new position on the meaning of § 67(e), the third he has put forward during the pendency of this litigation. He does not defend his proposed regulation. He presents instead only the verbal test it contains, abandoning the proposed regulation's explicit, relevant instantiation of that test as one that calls for full deductibility of trust and estate investment advice fees, at least in some circumstances.

What he calls his "preferred" reading is that the statutory phrase "would not have been incurred" means "could not have been incurred." This reading is textually insupportable; it renders statutory language superfluous; it would, as the Commissioner's own brief reveals, create an administrative morass, despite § 67's conceded purpose to reduce costs of recordkeeping and auditing; and it ultimately excludes trust and estate investment management fees from full deductibility only because the Commissioner would apply it inconsis-

tently. This should all be unsurprising: The test was invented in error by the Court of Appeals below. It was never thought of before by the Commissioner, presumably because it is not what the text of the statute says. Indeed, he did not defend it even before this Court until its hurried inclusion in the proposed regulation he issued after the grant of certiorari in this case.

The Commissioner's Brief reveals further disarray. He asserts the statute is unambiguous (see Govt. Br. 32-33), while simultaneously (and inconsistently) arguing that it has "three linguistically permissible interpretations." Govt. Br. 7, 14. The first, he himself argues must be "rejected out of hand," id. 14; the next two are not textually supportable. All that appears to join the Commissioner's various positions is his insistence that they win this case for him. Yet at the end of the day he does not even have an explanation for why Congress would have wanted to subject fees like those for trust and estate investment management to the two percent floor. He urges only that they serve a purpose – to prevent income splitting – that even he concedes Congress did not have. Govt. Br. 37.

Just as this Court rejected the Commissioner's position in another recent case where "[t]he Commissioner . . . altered his arguments throughout the course of th[e] litigation," and, "particularly odd[ly]," "abandoned" the position that "predominated in the Commissioner's argument to the Court of Appeals," so, too, here this Court should reject each of the Commissioner's incompletely theorized proposed constructions. See *Gitlitz v. Commissioner*, 531 U.S. 206, 212 n.5, 218 n.8 (2001). The Court should adhere to the reading compelled by statutory text, structure and history, and reverse the judgment below.

## ARGUMENT

### I. Petitioner's Reading of the Statute is Correct.

Section 67(e) permits the deductibility in full of "costs which are paid or incurred in connection with the administra-

tion of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e). That language establishes a straightforward causation test: an inquiry into whether a particular expense is due to the fact that the property was held in the trust or estate. Pet. Br. 22-23. A trustee's decision to obtain investment advice for the trust or estate is always a consequence of the trustee's demanding fiduciary duties regarding investments. Id. 6-10. That decision involves the exercise of fiduciary judgment. The advice for which investment advisory fees pay is tailored precisely to the distinctive requirements imposed by those fiduciary duties. The investment advisory fees incurred by trusts and estates would not have been incurred had the property not been held in the trust or estate. They are therefore deductible in full under § 67(e).

The Commissioner does not refute this argument because he cannot. Instead he presents a caricature of our position: that costs are deductible in full if "they are 'incurred in fulfillment of the trustee's fiduciary obligation,' regardless of whether they would have been incurred in the absence of a trust." Govt. Br. 28-29 (quoting a portion of a sentence in Petitioner's Brief). That is not Petitioner's view.

Under Petitioner's reading of the statute (and its plain text) costs that would have been incurred regardless of who owned the property are subject to the two-percent floor. These include those costs "incurred in connection with the administration of the estate or trust" that are not affected by the trustee's unique fiduciary obligations, but that occur, just as they would for non-trustee owners, simply because of the trust's or estate's ownership of "the property." 26 U.S.C. § 67(e). Costs like trust and estate investment advice fees, on the other hand, are not costs that "would have been incurred" had the property not been held in the trust. That is why they are deductible in full.

Administrative costs of pass-through entities owned by the trust or estate are the archetypal example of costs subject

to the two-percent floor under the second prong of § 67(e). Even when a trust or estate owns such an entity, those costs are incurred by the pass-through entity (for example, an S-corporation) and not by the fiduciary of the trust or estate in fulfillment of any fiduciary obligation. Other categories of expense that similarly would have been incurred regardless of whether "the property" were held in the trust or estate include, for example, certain expenses incurred in connection with real property. See Pet. Br. 23. If investment property is held cooperatively or in a condominium, an association or condo fee associated with that property will be incurred regardless of who owns the property. It is attendant upon ownership of the property. It would be subject to the two-percent floor under § 67(e) because it would have been incurred even if the property had not been held in the trust or estate. Similarly, if a trust or estate owned a vehicle (for example, a decedent's car), the legally mandated insurance costs, which would be incurred by whomever owned the property, would be subject to the two-percent floor.[1]

The Commissioner concedes that ensuring that this type of cost was subject to the two-percent floor was precisely Congress's purpose in adding the second prong to § 67(e). The Commissioner agrees, as he must, that the statutory history demonstrates that "the addition of the second clause of 26 U.S.C. 67(e)(1)" was designed specifically to prevent deduction in full of administrative costs "passed down to [a trust] from pass-through entities in which the trust had invested." Govt. Br. 37. The Commissioner further concedes what the text of § 67 and the Internal Revenue Code more broadly reveal, that Congress was in fact unconcerned about the risk of income splitting between an individual and a non-

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[1] As these examples show, the Commissioner is wrong to state that "all expenses" incurred "in connection with the administration of" a trust or estate are incurred in fulfillment of the trustee's unique fiduciary duty. Govt. Br. 31 & n.10. Petitioner's reading does not render any language in § 67(e) superfluous. See Pet. Br. 23.

grantor trust or estate, the sole purpose he has put forward in support of his broad reading of the statutory exception to full deductibility. See id. 37. As this Court's recent decision in *Powerex Corp. v. Reliant Energy Systems* makes clear, such "statutory history" – unlike the often-debated "legislative history" reflected in Committee Reports, floor statements, and hearing transcripts – is an uncontroversial tool in determining the meaning of statutory text. 127 S. Ct. 2411, 2416-17 (2007) (per Scalia, J.). The concessions in the Commissioner's brief virtually prove Petitioner's case.

The conclusion is inescapable that Congress, in enacting § 67, did not intend dramatically to alter pre-existing law. See former 26 U.S.C. § 57(b)(2) (1977); Pet. Br. 12-13. Congress sought only to extend the two-percent floor to certain, limited trust- and estate-incurred costs like the administrative expenses incurred by pass-through entities owned by trusts and estates. Congress did not intend, as the Commissioner insists, to subject almost all of the costs incurred in connection with the administration of a trust or estate – including, prominently, trust and estate investment advisory fees – to the two-percent floor. The Commissioner's argument is especially implausible given that his construction would make § 67(e) inconsistent with the rest of the Code and indeed with the thrust of the very Section in which the language appears. See 26 U.S.C. § 67(c) (exempting trusts and estates from being treated as pass-through entities).

We agree with the Commissioner that the language used by Congress was not expressly limited to administrative costs of pass-through entities, but went "beyond the principal evil to cover *reasonably comparable* evils." Govt. Br. 35-36 (emphasis added) (quoting *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998)). Section 67(e) does not, contrary to the Commissioner's contention, impose the two-percent floor on all costs that individuals are capable of incurring, or all costs customarily or commonly incurred by individuals. In addition to pass-through costs, the two-percent floor covers only trust and estate costs "reasonably

comparable" to those pass-through costs, like those we have described above.

Petitioner's interpretation of the statute draws a clear and readily administrable line, which is what all agree Congress intended. On one side of the line are costs caused by the fact that the property is held in the trust or estate. These remain fully deductible. On the other side are costs that would have been incurred regardless of who owned the property held in trust, including archetypally (but not exclusively) administrative costs associated with pass-through entities in which the trust or estate, rather than an individual, happens to have an ownership interest.

The various alternatives the Commissioner has proposed, in contrast, are so complex that the Commissioner thinks they will require (in one case) an unprincipled "safe harbo[r] or other guidance" concerning "allocation methods" in order to be manageable, Govt. Br. 24 n.7, or (in another case) a determination both of "the relevant population in which the expense must be 'common' (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria)," and of "what fraction of that population must incur an expense before the expense is considered 'common,'" as well as a "trial" concerning each expense "to determine what fraction of the population actually incurs the expense." Id. 21-22.

Petitioner's is the only reading of the statute consistent with the tax treatment of trusts and estates otherwise embodied in the text and structure of § 67, the 1986 Act in which it was adopted, and the Code more generally – something the Commissioner fails even to address. See Pet. Br. 23-31. The text, structure and history of § 67, the 1986 Act, and the Code more broadly thus all confirm Petitioner's reading of the statute.

## II. The Commissioner's New, "Preferred" Reading is Wrong.

The Commissioner's "preferred" reading of the statute sets out another new position on the meaning of § 67(e), the

third he has put forward during the pendency of this litigation. The Commissioner suggests that the "best" reading of the phrase "costs . . . which *would not* have been incurred if the property were not held in such trust or estate," 26 U.S.C. § 67(e) (emphasis added), is to refer to costs which "*could not* have been incurred by an individual property owner." Govt. Br. 20 (citing Pet. App. 13) (emphasis added).

Although his reading uses the verbal formulation contained in his proposed regulation, the Commissioner does not actually defend that regulation, but argues something new. The proposed regulation includes an explicit instantiation of that test with respect to precisely the type of fee at issue here. It says that the only investment advice fees subject to the two-percent floor are those for "advice on investing for total return" – the investment strategy prescribed for individuals by modern portfolio theory. Pet. Br. App. 14a (Proposed 26 CFR 1.67-4(b)); see Pet. Br. 17-18. Indeed, it expressly requires the taxpayer to "identify the portion (if any) of the . . . investment advisory . . . fee, commission or expense that is . . .not subject to the 2-percent floor." Pet. Br. App. 15a (proposed 26 CFR 1.67-4(c)).[2] The Commissioner does not de-

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[2] That this is what the proposed regulation means was confirmed in public remarks by a representative of the Office of Tax Legislative Counsel in the Department of the Treasury's Office of Tax Policy at an American Law Institute-American Bar Association program on September 20, 2007, just weeks before the Commissioner filed his brief in this case. The representative explained that under the proposed regulation the question was whether the services for which a fee was incurred were "obtained for purposes that are unique to fiduciaries that will not be subject to the two-percent floor. . . . If you have something like . . . investment advisory fees that . . . [were] incurred in part for services that are unique and in part for services that are not unique, you're going to have to apportion them. . . . Now the reg. also gives some bright lines in terms of what is clearly not deductible, not exempted from the two-percent floor, and that talks about investment advisory fees incurred for investing for total return. . . ." Responding to the moderator's observation that "I would have thought that investing for reasonable income and reasonable growth would have been unique to fiduciaries," she explained, "That's what we're saying. . . . If you're investing for total growth, total return,

fend this interpretation of the statute, presumably because the concession it implies – that fees for advice about investment of trust or estate assets that differs from that provided to individuals are, indeed, deductible in full – would be fatal to his case.

**A. Text.** The statute asks whether costs "would not have been incurred if the property were not held in such trust or estate." The Commissioner struggles to show that "would not" means "could not." But none of his verbal gymnastics can do that.

His primary argument, that when you remove the double negative "would not" means "could not," is just wrong. Govt. Br. 18. Asking without a double negative what costs "would not have been incurred if the property were not held in such trust or estate," is to ask what costs were incurred because the property was held in such trust or estate. That is precisely how Petitioner reads the statute.

The Commissioner also ignores the subjunctive form of the phrase "would not," then, treating the word "would" merely as the past tense of the verb "will," changes the tense of the word to try to prove his point. Id. But, as he elsewhere reminds us, "Congress' use of a verb tense is significant in construing statutes." Id. 30 n.9 (quoting *U.S. v. Wilson*, 503 U.S. 329, 333 (1992)); see *Sutton v. United Air Lines, Inc.*, 527 U.S. 471, 482 (1999). And even that change of tense would not suffice to help the Commissioner, since saying one "will not" incur an expense does not mean he or she "could not" incur it. His argument requires the further leap – not a part of the statutory text regardless of verb tense

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without having to worry about how much is income and how much is principal growth, that's the same as any investor is going to be doing. Whereas I don't think any individual would invest to produce X amount of income and X amount of principal growth and balancing those. . . ." Remarks of Catherine V. Hughes at the ALI-ABA program "Advanced Estate Planning Practice Update," audio at 4:30-5:39, 7:57-8:46, available for download through http://www.ali-aba.org/index.cfm?fuseaction=online.course_products&containerid=39231).

– that "the only way to be certain" that improper expenses are not deducted is to limit those deductions to those that "could not" be incurred by individuals. Govt. Br. 19.

The Commissioner's "parsing" of the logical structure of the clause suffers from additional infirmities. First, the Commissioner purports to "reorder" the statutory provision – though without mentioning it, he drops the word "such," so that his inquiry is no longer about ownership by the trust or estate at issue, but simply about property "held in trust" – something that inappropriately changes the focus from the action of the trustee of the particular estate or trust holding the property to the abstract category of the type of entity holding the property. Govt. Br. 19-20. When he replaces the actual language of the statute with the letters A and B, he again changes the tense of the statute. Id. Without this sleight of hand, a properly "reordered" version of the second prong would read "if the property were not held in the trust or estate, the cost would not have been incurred." This is "the logical equivalent of the proposition," id. 20, that the cost was incurred because the property was held in the trust or estate, the very reading Petitioner has urged all along. See David Hume, An Enquiry Concerning Human Understanding 83 (Open Court Publishing 1949) (reprint of posthumous edition of 1777) (classically explaining that counterfactual conditional phrases, like the one in § 67(e), ask about causation). Any example using the structure of the second prong proves this: "We would not have rented the car if we were not driving to Akron" means that the need to drive to Akron caused the rental of the car. The second prong states a test of causation, just as Petitioner has asserted.

And indeed, even with his sophistical twists and turns, the Commissioner's parsing still does not show that "would not" means "could not." The proposition that he claims is logically equivalent to the one contained in the statutory sentence – "the cost would be incurred only if the property is held in trust" (Govt. Br. 20) – still contains the word "would." He must again make a leap, stating that "the only

costs" for which the statement in his rewritten and reordered clause is "always true" are those which "could not" be incurred by any individual. Id. 20. But of course the statute does not ask about costs for which anything is "always true." It asks about costs that would not have been incurred if the property were not held in the trust or estate.

This reflects the inescapable problem with the Commissioner's countertextual reading of the statute. "Would not" does not mean "could not." To show that a cost "would not" have been incurred by a non-trust owner of the property requires no "categorical negation of the possibility" (id. 19) of such expenditure. In a candid sentence in the midst of his argument, the Commissioner says, correctly, "*one reason* that a cost would not be incurred in certain circumstances is that it could not be incurred." Id. 18 (emphasis added). Of course that is our point: many things that would not have occurred except for some event or circumstance *could have* occurred in the sense that they were possible. And, conversely, expenditures that no non-trust owner *could* have incurred are included in but do not exhaust the category of those that non-trust owners would not have incurred.

The Commissioner's own example demonstrates Petitioner's point. When one says "that a team would not have won the game if it were not for the quarterback's outstanding play," id. 19, one is saying his play was the cause of the victory. The team won because of the quarterback's play. One is not saying that it is impossible for any team to win without that quarterback. Yet this is the "impossiblity test" the Commissioner advocates.

The statutory language asks whether a cost "would not have been incurred if the property were not held in such trust or estate." If Congress had meant the statute to say that the only costs that were deductible in full were those that an individual could be shown to a "certainty" not to be capable of incurring, id. 19, it would have used different and familiar language: It would have said "could not have been in-

curred." And indeed, the Commissioner actually concedes that both of his various proposed interpretations "essentially add" a "modifier" to the statutory text. Id. 22 n.5.[3]

**B. Superfluity.** The Commissioner's proposed test also would render the first clause of § 67(e)(1) superfluous. The example he gives to contest this actually proves the point. See Govt. Br. 20 n.3. The Commissioner characterizes losses from bad debts as something that would be screened out from full deductibility by the first prong because, he says, they are not "paid or incurred in connection with the administration" of the trust or estate. Id. But individuals are capable of incurring bad debts. They do so all the time. These costs would therefore be screened out for full deductibility by the second prong under the Commissioner's reading, because they are not expenses of a type that an individual "could not have incurred." Under the Commissioner's interpretation, then, the first prong of § 67(e) is superfluous. He is unable to provide a single example of a cost that an individual "could not have incurred" that is not also a cost incurred in connection with the administration of a trust or estate. This demonstrates, if the words of the test he proposes did not, that the Commissioner's reading of the statute is wrong. Pet. Br. 45-46.

**C. Administrability.** The Commissioner also asserts that his chosen construction is the "preferable" one because

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[3] The applicable canons of construction support Petitioner's reading of the statute. Pet. Br. 38-40. The Commissioner relies on an argument that exceptions to general rules in statutes should be read narrowly. Govt. Br. 12. In the absence of textual ambiguity, there is no warrant for resort to any such default rule. In any event, to the extent that the Commissioner's rule is appropriately applied here, it supports a narrow reading of the two-percent floor, which is an exception to the general rule of full deductibility for miscellaneous itemized deductions, see 26 U.S.C. § 212(2) (stating the general rule that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income."); cf. Pet. Br. 38. See *Commissioner v. Clark*, 489 U.S. 726, 739 (1989).

it "offers the most administrable approach." Govt. Br. 9, 21. He is wrong.

The Commissioner's rule is utterly unadministrable. As he describes, it requires "unbundling of unitary fees." Govt. Br. 23-24 n. 7. Given the utter complexity of determining, for example, the precise portion of a trustee's unitary trustee fee attributable to investment advice (assertedly subject to the two-percent floor) as against that portion representing some other service, the Commissioner's test will require taxpayers to make an "allocation" under "any reasonable method." Pet. Br. App. 15a. The difficulty of this task, plus the complexity and cost of auditing and litigating contestable apportionments of expenses under controvertible systems of allocation, plunges the taxpayer and the Commissioner into a morass. This is confirmed by public comments on the proposed regulation. See Appendix ("Rep. Br. App.") 3a-5a, 11a, 15a, 24a-25a (containing excerpts of these). The Commissioner recognizes this: indeed, he attempts to temper the problem created by application of his proposed standard with an offer of unprincipled "safe harbors" or other guidance concerning allocation methods. See Govt. Br. at 24 n.7; Pet. Br. App. 11a.

The difficulty of administering his rule not only demolishes the only argument the Commissioner has articulated for why he finds this textually insupportable construction "preferable," it also demonstrates that his construction is at direct variance with the intent of Congress. All agree that the purpose of the very adoption of the two-percent floor in § 67 was to get taxpayers and the IRS out of the business of doing precisely this kind of recordkeeping, allocating, and auditing. See Govt. Br. 33-34; Pet. Br. 24-25. Congress had no intention of introducing complex requirements for recordkeeping, cost allocation, and auditing in the very Section of the 1986 Act designed to eliminate that problem.

**D. Departure from Past Practice.** The Commissioner's proposed construction would also mark a radical

departure from the tax treatment given trust and estate expenses under the statute during the nineteen years since its adoption, subjecting fees and costs that he long agreed were fully deductible to the two-percent floor. While this alone might not definitively condemn a construction of the statute, it does suggest that his is not a plausible reading.

The Commissioner confirms the change, noting that, if his position is adopted, the IRS will, among other things, have to amend its Form 1041, as both attorney fees and accounting fees will no longer always be deductible in full. Govt. Br. 24-25 n.8. Attorney and accountant fees have not been broken out in IRS statistics, but, when combined with return preparer fees they totaled $3.171 billion in 2005. Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 5 (IRS 2007) available at http://www.irs.gov/pub/irs-soi/05fd01.xls. They would, presumably, like other trust and estate expenses, be subject to the unmanageable regime of unbundling and cost allocation the Commissioner's interpretation calls for.

And, while trustee fees are not explicitly mentioned in the proposed regulation, the Commissioner now asserts that they would be "subject to its general unbundling requirement." Govt. Br. 24 n.7. This represents a dramatic departure from his prior position of nineteen years that trustee fees (totaling $4.0 billion in 2005, see *IRS Tax Stats*) are fully deductible – a position explicitly articulated by each Court of Appeals to accept his argument that investment advice fees are not deductible in full. See, *e.g.*, Pet. App. 12a; *Scott v. United States*, 328 F.3d 132, 140 (CA4 2003).

**E. Reliance on Inconsistent Application of Expenses.**

Even under the Commissioner's proposed test, trust and estate investment management fees would be deductible. The Commissioner's argument to the contrary relies on *ad hoc* and unprincipled distinctions among expenses.

Under the Commissioner's test "it is the type of product

or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant." Pet. Br. App. 14a. He argues that "costs paid or incurred for fiduciary accountings, judicial filings required as part of trust administration, [and] the preparation and filing of fiduciary income tax returns," among others, are fully deductible. Govt. Br. 23. Yet these categories of cost are "incapable of being incurred by individuals" only at the level of generality that the Commissioner refuses to use in describing trust and estate investment advisory fees. Pet. Br. 42-43.

Thus, *fiduciary* accountings are, at a broad level of generality, the same as accountings carried out by individuals who are not fiduciaries, for example, in the context of a divorce or a guardianship. The specifics compelled by the trustees' fiduciary duties, however, mean that the costs of fiduciary accountings are actually paying for a distinct service that individuals do not buy. Similarly, judicial filings *required as part of trust administration* are, at a broad level of generality, just like judicial filings by individuals. Even their subject matter may be identical. The same is true regarding *fiduciary* income tax preparation fees and the preparation fees for individual income taxes. See Pet. Br. 42-44.

As the Commissioner's position with respect to these costs correctly implies, when the services provided are distinct because they are tailored to the requirements of the fiduciary duty, the costs for such services are properly understood as distinct and incapable of being incurred by individuals. Because trust and estate investment advice must be tailored to the unique fiduciary duties of the trustee, the costs for such advice pay for a distinct service and they are, to precisely the same degree as each of these costs he concedes are fully deductible, incapable of being incurred by individuals.

The Commissioner has no answer to this point. Govt. Br. 25-26 (saying that neither the broadest nor the narrowest level of generality is correct, but not refuting Petitioner's claim that the Commissioner has been inconsistent in his

choice of level of generality); see Public Comments of the AICPA on proposed 26 CFR 1.67-4, Rep. Br. App. 11a ("the underlying logic for the classifications of different costs [by the Commissioner] is not explained and is inconsistent"). The Commissioner asserts that investment advice sought by trustees is not different in kind from the investment advice sought by individuals. Govt. Br. 26-27. But as Petitioner has explained, trustees' fiduciary duties do not allow them to make investment decisions in the same way as individuals would, or do. Pet. Br. 6-10. Among other things, only trustees need to balance the fiduciary obligation toward current and future beneficiaries and remaindermen, only they are bound to the distinctive "prudent investor standard," and only they face personal liability for failure to comply with their legal duties. Id.

The differences between trust investment advice fees and individual investment advice fees are at least as pronounced as the differences between the other fiduciary expenses the Commissioner recognizes are fully deductible and their individually-incurred counterparts. Should this Court adopt the Commissioner's test, it should apply it consistently to permit the full deductibility of trust and estate investment management and advisory fees.

**III. The Commissioner's "Alternative" Reading Is Also Wrong.**

The Commissioner also asserts (oddly and contradictorily) that he has not "abandoned" the different construction to which he long adhered, including in the court below, that the statute permits full deductibility only of costs of a type not "customarily" incurred by individuals. Govt. Br. 21 n.4. This "alternative" construction, too, is textually unsupportable and even the Commissioner now admits it is unworkable. Id. 21-22.

As explained in Petitioner's brief, the text does not ask whether expenses are "customarily" incurred outside of trusts. Pet. Br. 46-48. The Commissioner rehearses the

same arguments put forward below in support of this construction, still relying on the misuse of a dictionary definition of "would" – to refer to "custom or habitual action" taken in the past (e.g., "when we were young, we would go to the park every day") – that is wholly inapplicable here. Govt. Br. 20.[4]

As to workability, the Commissioner himself asserts that his alternative test would require a determination both of "the relevant population in which the expense must be 'common' (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria)," and of "what fraction of that population must incur an expense before the expense is considered 'common,'" as well as unimaginable "trial[s] to determine what fraction of the population actually incurs the expense." Govt. Br. 21-22. That cumbersome regime cannot be what was intended by a Congress seeking to ease administration of miscellaneous itemized deductions. And in the end, even the Commissioner rejects it. Id.

Finally, the Commissioner urges incorrectly that if this Court adopts that test, Petitioner should lose because he has failed to prove that investment management fees are not "customarily" incurred by individuals, and, the Commissioner asserts, under Tax Court rules Petitioner has the burden of proof on factual issues. Id. 28. This argument is easily dispensed with. The Commissioner has never put forward any evidence that such fees *are* customarily incurred by individuals, something that is far more likely to be available to him than to Petitioner, the CPA trustee of a family trust. As this Court has made clear, before the burden of proof is imposed on a taxpayer, the Commissioner must meet his burden of production: "[A] 'naked' assessment without any foundation" cannot be used to impose the burden of proof,

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[4] He attempts to bolster this with another dictionary definition, but selects another irrelevant one – to express "disposition or inclination," id., as in the phrase "I would propose we meet at noon." See Webster's Third New International Dictionary of the English Language 2638 (1986).

and thus tax liability, on a taxpayer. *United States v. Janis*, 428 U.S. 433, 441-442 (1976). On this record, therefore, under the Fourth and Federal Circuits' test, reversal would be the proper course.[5]

**IV. The Legislative History Confirms Petitioner's Reading of the Statute.**

This Court need not resort to legislative history because an examination of the statute's text, structure and history, along with the text and structure of the Code more broadly, demonstrates that it is unambiguous. Pet. Br. 31. In any event, the legislative history supports Petitioner here, and the Commissioner does not come to terms with it.

The Commissioner continues to cite a Senate Report issued before the second prong of § 67(e) was added to the bill, and asserts only that eliminating the deduction for investment advice fees is "consistent with" the "broader history of the Tax Reform Act of 1986." Govt. Br. 33. Specifically, he repeats his old argument that § 67(e) should be read as he urges because it "advances the goal" of deterring individuals from "split[ting] income" between a trust and its beneficiaries in order to obtain a tax benefit. Id. 34-35. The Commissioner never mentions the fact that the statute applies to "estates" as well, see id. 3 n.1 (refusing to address

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[5] The unremarkable assertion by this Court in a 1940 case that "a conservator of an estate, a custodian of a portfolio, a supervisor of a group of investments, a manager of wide financial and business interests, or a substantial stockholder in a corporation engaged in conserving and enhancing his estate" might deduct under § 162 as "ordinary and necessary expenses paid or incurred . . . in carrying on" their "trade or business" the "cost of investment counsel or of investment services," Govt. Br. 28, does not support the Commissioner's claim. See *Deputy v. DuPont*, 308 U.S. 488, 496-497 (1940). This case involves no taxpayer engaged in investment as a trade or business. The fees here were deducted under 26 U.S.C. § 212. Nor does "ordinary and necessary" mean "customarily incurred." See 26 CFR 1.212-1(d) (to be "ordinary and necessary," expenses must "bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income").

them), and of course there is no way (short of committing suicide) deliberately to set up an estate to split income between it and its beneficiaries. Pet. Br. 28. That alone refutes the Commissioner's argument.

More fundamentally, though, the Commissioner acknowledges, as described above, that "trusts and estates when they function like pass-through entities" "pose little risk of abuse," Govt. Br. 37. Congress recognized this in its treatment of trusts and estates in § 67(c) and throughout the Code, see, *e.g.*, 26 U.S.C. § 68(e), and in enactments both before and since the 1986 Act. Pet. Br. 30-31.

This concession deals the Commissioner's case a body blow. There is both specific statutory text and specific legislative history making clear that Congress thought significant changes in the taxation of trusts and estates was unnecessary to prevent the income-splitting that the Commissioner now urges as the sole purpose served by his reading of the second prong of § 67(e). Pet. Br. 37. Like so much else that conflicts with his position, the Commissioner leaves this – and indeed the very nature of trusts and estates and their taxation described by Petitioner, Pet. Br. 26-28 – unaddressed.

The Commissioner does not explain why the Congress that exempted trusts and estates from being treated as pass-through entities in § 67(c) would have nonetheless subjected almost all of their expenses to the two-percent floor.[6] He

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[6] Recognizing that these expenses have no personal component, the Commissioner suggests that Congress had a purpose in enacting the two percent floor to "simplify" tax administration that was distinct from its goal to prevent deduction by individuals of expenses with a personal aspect. Govt. Br. 33-34. But the congressional goals of "simplification" and "limit[ing] deductions for personal expenses" are one and the same. Id.; see Pet. Br. 25 (explaining this). It was because some portion of some individual expenses (including some he lists, *e.g.*, continuing education) was, in fact, often personal, that recordkeeping and auditing were burdensome. Congress grouped certain individual deductions, including but not limited to these, into the category denominated "miscellaneous itemized deductions." It then permitted a deduction for these costs *in the aggregate* only to the extent that they exceeded two percent of adjusted

does not dispute that prior § 57(b) made trust and estate investment management fees fully deductible before the adoption of the 1986 Act even when similar costs incurred by individuals were not. Pet. Br. 12. Nor does he dispute that the original versions of what is now §67(e) that passed both Houses of Congress contained that same rule. Id. 32. And indeed, as described above, he concedes that the specific problem that the new second prong was added in Conference to address was the possibility that trusts and estates might deduct in full expenses incurred by pass-through entities in which they held an ownership interest, Govt. Br. 37-38, something reflected in the Conference Report.[7]

The Commissioner resists the clear conclusion that the statute's language must be read to prevent only those and similar deductions, not dramatically to alter pre-existing law concerning the treatment of trust and estate administrative expenses. He provides no good reason for reading § 67(e) to prevent full deduction of trust investment management fees.[8]

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gross income. This method was designed to provide "rough justice" by in essence disallowing what Congress thought could fairly be deemed the personal *component* of those *aggregated* costs. Pet. Br. 24-25, 32-33.

[7] The Commissioner incorrectly asserts that the portion of the Conference Report quoted by Petitioner does not relate to Section 67(e). Its next-to-last sentence makes clear that it does. See Pet. Br. 35.

[8] The Commissioner appears to concede that his proposed regulation would not at this time be entitled to deference even in the face of statutory ambiguity. Govt. Br. 7; see Pet. Br. 48-49 n.33. Most of the public comments submitted on his proposed regulation – all of which disagree with his interpretation of § 67(e) – formally ask the Commissioner to extend the comment period or withdraw or hold in abeyance the proposed regulation until after this Court's ruling in this case in order to permit those comments or the agency's regulatory action to be informed by this Court's decision. See, *e.g.*, Rep. Br. App. 2a, 6a (American Bankers Association); 7a-8a (ABA Section of Real Property, Trust and Estate Law), 10a-12a (AICPA), 14a, 16a (AmeriServ Trust and Financial Services Company), 19a-21a (N.Y. City Bar). As of the date of filing of this brief, the Commissioner has not agreed to do so. See id. 8a.

**V. As Economic Theory Predicts, Individuals Will Act at the Margin to Minimize Taxation.**

Finally, the Commissioner erroneously suggests that trustees will not be deterred from seeking professional investment advice in fulfillment of their fiduciary duties by what he, the tax collector, calls "such a small amount of tax." Govt. Br. 39. Under the current top tax bracket, however, the tax will amount to as much as 35% of the cost incurred. The Commissioner falsely claims the tax will be limited to "0.7% of the trust's income." Govt. Br. 39. He is apparently referring to *adjusted gross income*, not *taxable income*. The additional tax could in fact be *any* percentage of the trust or estate's taxable income. Pet. Br. 10-11. Further, as the Commissioner knows, because of the Alternative Minimum Tax, the tax will not in any event be limited even to 0.7% of adjusted gross income.

In the real world, individuals act – as economic theory predicts – at the margin to minimize taxes, and the Commissioner's approach would provide plenty of incentive. See Pet. Br. 40-41; Rep. Br. App. 23a-24a (comments of Northern Trust Company). Indeed, his brief suggests further reason for concern. If trustee fees, too, are no longer fully deductible, the consequences for the banking industry, which provides most professional trustee services, and for the management and operation of trusts and estates, could be profound. Grantors and beneficiaries will tend to avoid using professional services in favor of trustees who are willing to serve at no cost – less skilled relatives, for example, or friends. At a time when state trust and estate law has been pushing toward the professionalization of the advice given to trusts and estates, for example by adoption of the "prudent investor" standard, Pet. Br. 7-10, it would make no sense to conclude that Congress intended such a perverse result.

## CONCLUSION

The judgment of the Second Circuit should be reversed.

Respectfully submitted,

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NOVEMBER 2, 2007

# APPENDIX

**APPENDIX A**
**Comments of The American Bankers Association**
**(Excerpt)**

*ABA*
AMERICAN BANKERS ASSOCIATION ®

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October 24, 2007

Ms. Linda E. Stiff
Acting Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Ave, NW
Washington, D.C. 20044

Re: *Section 67* Limitations on Estates and Trusts; REG-128224-06; 72 Federal Register 41243 (July 27, 2007).

Dear Ms. Stiff:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Internal Revenue Service's (IRS) proposed amendments to regulation *26 CFR 1.67*. The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership -- which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest banking trade association in the country.

Many ABA members provide fiduciary and related services to individual and institutional clients. As of the end of

2006, approximately 1800 banks and thrifts held more than $ 19 trillion in fiduciary assets for both retail and institutional customers in 19 million accounts.[1] In their fiduciary capacity, these banks provide a number of services to customers of all kinds, such as trust administration, investment management, custody of assets, tax preparation and accounting. While acting as a fiduciary or trustee, banks must follow strict duties of loyalty, prudence, and care to the trust and its beneficiaries and are subject to liability for failure to comply with their fiduciary responsibilities. In exchange for providing trust and fiduciary services, banks charge fees that would be subject to the proposed amendments. As a result, the banking industry is very concerned about the proposal and the potential deleterious impact it would have on trusts and estates, their beneficiaries, and the banks that serve as fiduciaries for these accounts.

BACKGROUND

* * *

For several reasons, ABA respectfully opposes the proposal and urges, at a minimum, that the IRS delay any consideration of regulatory action until after the Supreme Court has decided the matter. First, the proposal misinterprets the plain meaning of *Section 67* and which expenses may be deducted in full. Second, the proposal ignores the significant and extensive fiduciary responsibilities imposed on trustees by state laws and the governing trust instruments that require trustees, in performing their fiduciary responsibilities, to consider investment management services. Third, not only is the proposal administratively difficult and costly to implement, but it also is likely to be harmful to beneficiaries.

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[1] FDIC Call Report Data, December 2006. As used in this letter, the term "banks" includes banks, savings associations, and trust companies that act in fiduciary and related capacities.

PLAIN MEANING OF SECTION 67(e)

* * *

FIDUCIARY RESPONSIBILITIES OF TRUSTEES

* * *

PRACTICAL CONCERNS AND ADMINISTRATIVE AND INDUSTRY BURDENS

The proposal, which would require bank trust departments and others to "unbundle" the fees charged to administer trust accounts, would be impractical and very costly to implement. Typically, banks charge each trust account a single fee for its administration. This fee covers fiduciary administrative services, including custody, tax return preparation, as well as investment services.

Separating the "unique" components of trust fees is a time-consuming and very burdensome exercise. Because of the very specialized nature of trust administration and significant fiduciary liability incurred, many institutions have a multiplicity of fee schedules for various types of trust accounts. These numerous fees schedules reflect the highly customized services offered and the specific needs of the beneficiaries. In other words, two trust accounts of a similar size and type could be charged two different fees depending on several factors, including asset mix, complexity of family situation, trust terms, number of beneficiaries, and structure of mandatory versus discretionary payments of income or principal. How then would the bank systematically and accurately determine the portion of fees that are "unique" for the two trust accounts? Such an allocation is far from a standardized process, and would likely require extensive individual determinations. Individual determinations, in turn, may lead

to the inequitable treatment of trust accounts and thus cannot be supported from a fiduciary standpoint.

Furthermore, assuming that compliance with the proposal is possible through a computerized process, the expense of that compliance would be significant. Invariably, bank trust departments would have to create yet another computer system to track, calculate, and separate the fees that are deductible from those that are not.[2] This system must be tested to ensure that it properly tracks the information, as well as periodically adjusted to accommodate new or different services the bank offers to each trust. Furthermore, the bank must institute on-going training programs for employees. All of these expenses would result in a significant cost for all institutions. This expense is especially burdensome for the hundreds of smaller institutions[3] that offer trust and fiduciary services and typically employ fewer than twenty full-time employees. Often these institutions employ no more than a handful of personnel in the trust department.

In addition to fulfilling their tax accounting and reporting duties, these trust department employees would now need to spend their time "unbundling" trust fees for the previous tax year. This complex and time-consuming activity, especially for smaller institutions with few employees, will likely delay other necessary tax reporting activities, such as issuing Schedule K-1s to trust beneficiaries. This delay could in turn cause those taxpayers to ask for an extension in their tax filings. Trust tax returns and tax information sent to beneficiaries must be completed in an extremely short amount of time -- especially when trustees must wait for records from partnerships. Under the proposal, the amount of time available to

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[2] The most popular computer systems used by bank trust departments are not capable of "unbundling" and tracking the trust fees.

[3] According the FDIC Quarterly Banking Profile for 2006, 400 banking institutions with assets under $100 million exercise fiduciary powers, such as acting as a corporate trustee.

compile the necessary tax forms would be further shortened if trustee institutions were required to comply with complex unbundling requirements. In the end, this requirement will not only burden trusts and estates and the bank trustees that serve them, it will also make the tax compliance system less efficient.

All of these practical concerns with implementing the proposed regulation would very likely lead to an increase in the fees for administering the trust. This increase in fees would incorporate the additional time and expense of training staff, creating new records systems, and making labor-intensive decisions about how to "unbundle" the fees properly. The costs associated with unbundling trust and estate fees will be passed on to the trust beneficiaries. We further submit that even under the proposal, the costs associated with "unbundling" would be fully deductible from the trust income, as they would be incurred as a result of the assets being held in trust.

In the end, we question who is helped by this proposal; certainly not the bank trustees who must spend resources to unbundle their fees, nor the beneficiaries that will incur higher fees to compensate trustees for their labors. We question how much the U.S. Treasury will benefit if our position is correct that costs associated with unbundling fees would be fully deductible.

EFFECTIVE DATE OF THE PROPOSED RULE

* * *

CONCLUSION

In conclusion, ABA appreciates the opportunity to offer our comments on the Section 67 proposal. At a minimum, the IRS should not move forward with this proposal until the

Supreme Court has had an opportunity to rule on the merits of the case before it. In addition, we would strongly urge the IRS to abandon this proposal, as it ignores the significant fiduciary duties of trustees and leads to far greater burdens than benefits.

Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053 or Lisa Bleier at (202) 663-5479.

Sincerely,
/s/ Phoebe A. Papageorgiou
Phoebe A. Papageorgiou
American Bankers Association
Washington, D.C.

**APPENDIX B**
**Comments of the American Bar Association Section of Real Property, Trust and Estate Law (Excerpt)**

**COMMENTS OF THE REAL PROPERTY, TRUST AND ESTATE LAW SECTION OF THE AMERICAN BAR ASSOCIATION**

**REG-128224-06**
**(Section 67 Limitations on Estates or Trusts)**

**October 25, 2007**

* * *

**Comments and Recommendations**

**I. Withdraw Proposed Regulations or Extend Comment Period Until After the Supreme Court Has Ruled in *Rudkin*.**

The Supreme Court has granted *certiorari* in *Rudkin*, and will examine this issue directly. Its decision in that case may address the different considerations and standards raised in decisions issued by four United States Courts of Appeals and may reconcile or eliminate the differences in opinions as to the scope of Section 67(e). *Certiorari* was granted in *Rudkin* even though the Treasury had opposed its grant. Treasury argued that the grant of *certiorari* was unnecessary because Treasury had prepared proposed regulations addressing the issue to resolve the different treatment of taxpayers in different circuits and would issue the proposed regulations shortly. Given the Court's implicit rejection of Treasury's position, it is appropriate to defer the regulatory process until the Supreme Court issues its opinion.

A member of the Section made an inquiry to Mr. Eric Solomon, Assistant Secretary for Tax Policy, as to whether Treasury would withdraw the Proposed Regulations or extend the comment period until at least 90 days after the Supreme Court issues its decision. Mr. Solomon would not give any assurance that Treasury would do either. Because we do not know whether the Proposed Regulations will be withdrawn, we address them in these comments. If the Proposed Regulations are not withdrawn, we respectfully request that the period to comment on the Proposed Regulations be extended until 90 days after the Supreme Court renders its decision in *Rudkin* to permit all interested parties to have the benefit of the reasoning in the Supreme Court's decision in formulating their comments. In conjunction with extending the comment period, we also respectfully request that the public hearing scheduled for November 14, 2007, be delayed until 30 days after the close of the extended comment period to avoid the possible need for a second hearing.

* * *

## APPENDIX C
## Comments of The American Institute of Certified Public Accountants (Excerpt)

October 8, 2007

Ms. Linda Stiff
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. Donald Korb
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. William P. O'Shea
Associate Chief Counsel for Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

HAND DELIVERED: Courier's Desk, CC:PA:LPD:PR
(REG-128224-06)

**RE: Proposed Regulations (REG-128224-06) 2007-36 IRB 551, Regarding Guidance on Which Costs Incurred by Estates or Non-grantor Trusts Are Subject to the 2-Percent Floor for Miscellaneous Itemized Deductions Under Section 67(a)**

Dear Ms. Stiff and Mssrs. Korb and O'Shea:

The American Institute of Certified Public Accountants (AICPA) is submitting comments on proposed regulations relating to guidance on which costs incurred by estates or non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a).

The AICPA is the national professional organization of certified public accountants comprised of approximately 330,000 members. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

We respectfully request that the comment period for the Proposed Regulations [REG-128224-06] be extended to end 90 days following the Supreme Court decision in Rudkin,[1] for the following reasons:

1. The proposed regulations provide little in the way of additional clarification of the statute. As a definition of eligible costs, the regulations merely repeat the statutory language, with an inconsistent substitution of the verb "could" for "would." For example:

   a. Section 67(e)(1) defines eligible costs, in part, costs "which would not have been incurred if the property were not held in such trust or estate."

   b. Proposed reg. section 1.67-4(b) states that an eligible cost is a "unique" cost, which is, in turn, defined as a cost where "an individual could not have incurred that cost in connection with property not held in an estate or trust."

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[1] Michael J. Knight v. Commissioner, No. 06-1286.

The proper interpretation of such language -- which is at the heart of the Circuit split -- is not explained further in the regulations.

2. The proposed regulations provide a list of eligible and non-eligible costs. However, they are of limited value because the underlying logic for the classifications of different costs is not explained and is inconsistent. For example, tax preparation costs incurred by trusts, appropriately, are held to be an eligible cost, while investment advisory fees incurred by trusts are not. Although both individuals and trusts incur tax preparation costs, the regulations, correctly, make the distinction between tax preparation fees incurred by trusts and those incurred by individuals based on the difference in reporting forms (Form 1041 vs. Form 1040) and tax law uniquely pertaining to trusts. Using the same logic, the nature of the investment advice for trusts -- for example, advice to carry out the specific terms of a trust, to achieve a certain balance between the income and remainder beneficiaries, or to comply with the prudent investor laws uniquely pertaining to trusts - -should render the fees for such advice fully deductible.

3. The portion of the proposed regulations that deals with unbundling fees will require trustees to develop allocation methods for bundled fees charged by a variety of vendors, including passthrough entities that do not provide the needed information. Corporate trust departments must explore the technical feasibility of the various options. Attorneys must consider the impact of attorney-client privilege on providing detailed disclosures to third parties. Requesting commentators to invest significant amounts of time to investigate options and propose such methods -- prior to the Supreme Court's ruling on the tax treatment of such items -- is unfair and burdensome because the Court's ruling may make these options moot.

4. Although the United States Courts of Appeals have interpreted the language differently, none of them have found the statute's language to be ambiguous. Acting under the Chevron doctrine[2], courts are required to defer to certain agency interpretations of ambiguous statutory provisions, provided the agency's interpretation reasonably resolves the ambiguity. However, if the statute is unambiguous, the courts are not required to defer to the agency's interpretation. None of the courts have held IRC section 67(e)(1) to be ambiguous. Therefore, the proposed regulations, even if finalized, are of no or limited value in resolving the present Circuit split prior to the Supreme Court's decision.

Based on the above, we respectfully request that the IRS extend the comment period for the proposed regulations to 90 days following the Supreme Court decision in Rudkin.

* * *

We thank you for the opportunity to present our comments and welcome the opportunity to discuss our comments further with you or others at the IRS. Please feel free to contact me at (212) 773-2858, or jeffrey.hoops@ey.com; Steven A. Thorne, Chair of the AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at (312) 486-9847, or stethorne@deloitte.com; or Eileen R. Sherr, AICPA Technical Manager, at (202) 434-9256, or esherr@aicpa.org, to discuss the above comments or if you require any additional information.

Sincerely,

Jeffrey R. Hoops

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[2] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)

Chair, AICPA Tax Executive Committee
Washington, D.C.

cc:
Mr. Eric Solomon, Assistant Secretary for Tax Policy,
Treasury Department
Ms. Catherine Hughes, Attorney Advisor,
Treasury Department
Ms. Jennifer N. Keeney, Attorney, Office of Associate Chief
Counsel for Passthroughs and Special Industries, IRS
Mr. George Masnik, Branch Chief, Office of Associate Chief
Counsel for Passthroughs and Special Industries, IRS

## APPENDIX D
## Comments of AmeriServ Trust and Financial Services Company (Excerpt)

AMERISERV
TRUST AND FINANCIAL
SERVICES COMPANY

October 9, 2007

CC:PA:LPD:PR (REG-128224-06)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

To Whom It May Concern:

AmeriServ Trust and Financial Services Company ("AmeriServ") appreciates the opportunity to provide comments on Prop. Treas. Reg. § 1.67-4 regarding the deductibility of certain costs paid or incurred by estates or non-grantor trusts.[4]

* * *

AmeriServ urges the IRS and Treasury (i) to amend Prop. Treas. Reg. § 1.97-4 to provide that costs incurred by fiduciaries to comply with obligations imposed under state law are fully deductible, and (ii) to extend the comment period beyond October 25, 2007 for a reasonable period following the

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[4] Unless otherwise indicated, references herein to "IRS" are to the Internal Revenue Service; references to "Code" are to the Internal Revenue Code of 1986, as amended; references to "Section" are to the specified sections of the Code; and references to "Treas. Reg. §" are to the Treasury Regulations promulgated under the Code.

Supreme Court's ruling in *Knight v. Commissioner* (No. 06-1286).

* * *

**Comments and Recommendations**

**1. Prop. Treas. Reg. § 1.67-4 should be amended to account for the manner in which fiduciary obligations impact costs incurred by non-grantor trusts and estates.**

* * *

AmeriServ also cautions that Prop. Treas. Reg. § 1.97-4 will have an unintended effect of increasing the costs of administration for estates and non-grantor trusts. Under the Regulation as proposed, fiduciaries will be required segregate their fees, which often are bundled at a savings to customers, into expenses that are unique to estates and trusts, and therefore fully deductible, and expenses that are not. Creating systems to track unique expenses will be difficult and costly and is likely to result only in increased fees. Smaller financial institutions may lack capacity to implement new systems, making compliance difficult for taxpayers. Accordingly, Prop. Treas. Reg. § 1.97-4 should be revised as recommended above for the added reason of avoiding a cumbersome systemic shift which will make estates and trusts expenses difficult and costly to track.

**2. Regulations interpreting Section 67(e) should remain proposed and subject to public comment pending the Supreme Court's decision in *Knight*.**

The comment period for Prop. Treas. Reg. § 1.67-4, which essentially codifies the Second Circuit's holding in *Rudkin*, ends on October 25, 2007. However, *Rudkin's* ultimate dis-

position will not be certain until the Supreme Court's ruling in *Knight*.

* * *

It is entirely possible that the *Knight* ruling will reverse the Second Circuit in *Rudkin* and thereby call into question the validity of Prop. Treas. Reg. § 1.67-4. The IRS and Treasury have less discretion implementing a statutory provision after a court decides what a statute means. Accordingly, AmeriServ urges the IRS and Treasury to extend the comment period for any proposed Regulations interpreting Section 67(e) for a reasonable period following the *Knight* ruling. Nearly fifteen years have passed since the first important ruling on this issue in O'Neill. The Supreme Court in its *Knight* opinion might invite Treasury and the IRS to clarify the area by writing regulations of any kind, but also might explain that Treasury's and the IRS's interpretive options under the clear statute are limited. There is no compelling reason to expedite Section 67(e) guidance in advance of the issuance by the Supreme Court of its opinion, especially where doing so could result in an additional lack of clarity.

Sincerely,
/s/ Ronald Virag
Ronald W. Virag
President and Chief Executive Officer

cc: Jennifer N. Keeney,
Office of the Associate Chief Counsel (Passthroughs and Special Industries)
Jeffrey H. Paravano
Natanya Holland Allan

**APPENDIX E**
**Comments of the Association of the Bar of the City of New York (Excerpt)**

**NEW YORK CITY BAR**

**COMMITTEE ON ESTATE AND GIFT TAXATION**

MICHAEL I. FRANKEL
CHAIR
2 WALL STREET
NEW YORK, NY 10005
Phone: (212) 238-8802
Fax: (212) 732-3232
frankel@clm.com

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October 24, 2007

***Via Electronic Submission and Express Mail***
***http://www.regulations.gov/***
***IRS – REG-12822406***

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-128224-06)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments to Proposed Treas. Reg. § 1.67-4 Concerning Whether Certain Costs Paid or Incurred by Estates or Non-grantor Trusts are Subject to the 2% of Adjusted Gross Income Floor

Dear Ladies and Gentlemen:

This letter sets forth the comments of the Association of the Bar of the City of New York to Proposed Treasury Regulation § 1.67-4, which was issued on July 27, 2007 (the "Proposed Regulations"). . . .

As discussed below, we strongly urge the Service to hold the Proposed Regulations in abeyance pending the Supreme Court's resolution of the Rudkin-Knight case,[2] which involves the construction of the specific statutory provision that is addressed by the Proposed Regulations, *to wit*, I.R.C. § 67(e) ("Section 67(e)"). We also request that the Service extend the comment period for the Proposed Regulations until 90 days after the Supreme Court decides Rudkin-Knight.

With respect to the substance of the Proposed Regulations, we believe that the Proposed Regulations are unreasonable in construing Section 67(e) to require that "bundled" trustee's fees and commissions be unbundled, and note that the Service's position is contrary to the views expressed by each of the federal appellate courts that have commented upon (and approved) the deductibility of trustee's fees without regard to the 2% Floor.[3] We also regard the Proposed Regulations to be somewhat arbitrary in their delineation between those costs that the Service considers "unique" to an

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[2] See Knight v. C.I.R., 127 S. Ct. 3005 (U.S. June 25, 2007) (granting for the certiorari from the Second Circuit's in William L. Rudkin Testamentary v. C.I.R., 467 F.3d 149 (2d Cir. 2006)).

[3] See Rudkin, 467 F.3d at 156; Scott v. United States, 328 F.3d 132, 140 (4th Cir. 2003).

estate or trust (and are therefore fully deductible without regard to the 2% Floor), and those costs that are not (which are therefore subject to the 2% Floor), and urge the Service to conform its classification scheme to the parameters that will soon be announced by the Supreme Court in the Rudkin-Knight case.[4]

## I. The Proposed Regulations Should Be Held in Abeyance Pending the Supreme Court's Decision in the Rudkin-Knight Case and the Comment Period Should Be Extended Until 90 Days after This Decision is Rendered

We were surprised that the Proposed Regulations were issued so soon after the Supreme Court's granting of certiorari in the Rudkin-Knight case, which involves the construction of the specific statute (Section 67(e)) that the Proposed Regulations interpret. It would be unfortunate if the Services' actions served to undermine the balance of power among the judicial, executive and legislative branches of the United States government. Moreover, as a practical matter, if the Proposed Regulations are finalized without taking into consideration the Supreme Court's forthcoming decision in the Rudkin-Knight case, taxpayers might find themselves in a conundrum where different standards for interpreting Section 67(e) will have been promulgated by the Service and the Supreme Court – thereby producing more litigation on this issue. Accordingly, we strongly urge the Service to reconsider its position, and to hold the Proposed Regulations in abeyance pending the resolution of the Rudkin-Knight case. In addition, to permit the Proposed Regulations to be evaluated in light of the Supreme Court's forthcoming guidance,

---

[4] Although these Comments only address the specific points set forth herein, we fully adopt and agree with the positions taken by the Petitioner/Taxpayer in the Rudkin-Knight case. Given the Service's extensive familiarity with the issues presented in that case, we have not repeated those arguments here.

we respectfully request that the Service extend the comment period for the Proposed Regulations until 90 days after the Supreme Court decides Rudkin-Knight.

**II. The Proposed Regulations' Requirement that "Bundled Fees" be Unbundled Should Be Eliminated**

* * *

**III. The Service Should Await Guidance from the Supreme Court before Delineating Categories of Costs**

* * *

Although we appreciate the Service's objective to provide taxpayers and their advisors with bright-line rules (notwithstanding that these rules may contain some internal inconsistencies), we believe that the better approach would be for any such guidelines to be informed by the standards that will soon be handed down by the Supreme Court in the Rudkin-Knight case. Accordingly, the issuance of these guidelines should be held in abeyance pending the Supreme Court's decision in Rudkin-Knight and the Service's review of comments to be submitted within 90 days after this decision is rendered.

Respectfully submitted,
/s/ Michael I. Frankel
Michael I. Frankel
Chair, Estate & Gift Taxation
Committee

* * *

**APPENDIX F**
**Comments of Northern Trust Corporation (Excerpt)**

The Northern Trust Company
50 South La Salle Street
Chicago, Illinois 60903
(312) 630-6000

# Northern Trust

CC:PA:LPD:PR (REG-128224-06)
Courier's Desk
Internal Revenue Service,
1111 Constitution Avenue, NW,
Washington, DC 20044

Testimony of Northern Trust Corporation before the
Internal Revenue Service
Public Hearing on Proposed Rules
Section 67 Limitations on Estates or Trusts
(REG-128224-96)
November 14, 2007

Ladies and Gentlemen:

On behalf of Northern Trust Corporation, I respectfully request permission to present oral comments at the public hearing scheduled for 10 am on November 14, 2007.

* * *

I have also enclosed a signed original and eight (8) copies of a written submission for the record.

Thank you for your consideration.

Very truly yours.

NORTHERN TRUST CORPORATION
By: /s/ Grace Allison
Grace Allison

Enclosures: 8 copies of topic outline
8 copies of written submission plus original

**Testimony of Northern Trust Corporation before the Internal Revenue Service**
**Public Hearing on Proposed Rules**
**Section 67 Limitations on Estates or Trusts**
(REG-128224-06)
November 14, 2007

Ladies and Gentlemen:

Thank you for the opportunity to make this presentation today.

I represent Northern Trust Corporation ("Northern Trust"), which has been in the business of administering trusts since its founding in 1889. Today, Northern is one of the largest trust companies in the world, with a network of 85 offices in 18 U.S. states, administering more than 15,000 irrevocable trusts nationwide.

* * *

***The Plain Meaning of Section 67(e)***

* * *

***Disparate Treatment of Mutual Fund Fees.***

It is also important to note that the proposed regulations, if made final, have the potential to disrupt the financial markets (and create another tax loophole) by providing a new incentive for all trusts to invest in mutual funds. This undoubtedly unintended consequence is caused by the asymmetry between the treatment of investment costs incurred by the mutual funds and the treatment, under the proposed regulations, of trust investment fees. The former are, pursuant to section 67(c)(2)(B), allowed as a direct offset to the fund's investment income; the latter, by regulation, would now be al-

lowed only to the extent that they exceed a 2% floor. To put it plainly, Treasury lacks the authority to require trustees to "unbundle" their fees, just as it would lack the authority to require mutual funds to pass their unbundled fees through to trust investors.

***Impracticality.***

In addition, the requirement to "unbundle" fees imposes an impractical burden on all trust companies, large and small, and would set a standard impossible to meet with any degree of precision. Put in an historical context, the proposed regulations rival the ill-fated carryover basis rules in the degree of administrative complexity they would entail if made final as proposed.

When providing trust services (whether as sole trustee or co-fiduciary), trustees must pay keen attention to the needs of beneficiaries. This means that services must be individualized—and the exact service mix will depend on a variety of factors, including the complexity of the family situation, the number of beneficiaries, the terms of the trust, and the type of assets under administration. For example, a trust administrator may spend many, many hours on a trust established for a disabled child or a distraught widow. In the same vein, a trust with 40 beneficiaries has different needs from a trust that benefits a single individual. Some of our accounts are simple trusts, requiring that all income be paid annually, with no discretion to distribute principal. In other trusts, however, distributions of both income and principal are left to the discretion of the trustee, with complex distribution standards requiring hours of fact-finding and analysis. In several of our large trust relationships, the predominant asset is closely-held stock of a family business; with this type of asset, discussions of family values are often as important—and far more difficult—than straight-forward investment briefings. As a consequence, the percentage of time devoted to trust

administration fluctuates widely from trust to trust and from year to year—and would be most difficult to quantify.

In pertinent part, the preamble to the proposed regulations states that:

> "whether costs are subject to the 2-percent floor . . . depends on the type of services provided, rather than on taxpayer characterizations or labels for such services."

Read literally, this would require Northern to detail its services on a minute-by-minute account-by-account basis. This is an impossibility in a corporate trustee environment, where some services are rendered to hundreds of trusts at the same time—and other services are required for more than one purpose. Is the cost of tax lot accounting, for example, most properly allocated to trust accounting (not subject to the 2% floor), to tax return preparation (not subject to the 2% floor) or to investment management (subject to the 2% floor)?

* * *

***Conclusion.***

In conclusion, we strongly urge Treasury and the IRS to withdraw the proposed Regulations, which are neither contemplated nor sanctioned by section 67, as ill-advised, impractical and expensive—both to the taxpayer and the IRS.

Respectfully submitted,

NORTHERN TRUST CORPORATION
By: /s/ Grace Allison
Grace Allison

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(7)

No. 06-1286

FILED
AUG 23 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

# IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## BRIEF OF AMERICAN BANKERS ASSOCIATION, CALIFORNIA BANKERS ASSOCIATION, FLORIDA BANKERS ASSOCIATION, ILLINOIS BANKERS ASSOCIATION, KANSAS BANKERS ASSOCIATION, MASSACHUSETTS BANKERS ASSOCIATION, MISSOURI BANKERS ASSOCIATION, NEW YORK BANKERS ASSOCIATION, NORTH DAKOTA BANKERS ASSOCIATION, OHIO BANKERS ASSOCIATION, PENNSYLVANIA BANKERS ASSOCATION, AND THE TEXAS BANKERS ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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*August 23, 2007*

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No. 06-1286

# IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent*.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

## BRIEF OF AMERICAN BANKERS ASSOCIATION AND STATE BANKERS ASSOCIATIONS AS *AMICI CURIE*[1] IN SUPPORT OF PETITIONER

The American Bankers Association ("ABA"), the California Bankers Association, Florida Bankers Association, Illinois Bankers Association, Kansas Bankers Association,

[1] Pursuant to Rule 37.6, counsel for the parties has consented in writing (copies of which have been filed with the clerk) to the filing of this brief. Pursuant to Rule 37.6, counsel certifies that no counsel for any party authored this brief in whole or in part, and no person or entity other than the *amici curiae* or its members made a monetary contribution to the preparation or submission of the brief.

Massachusetts Bankers Association, Missouri Bankers Association, New York Bankers Association, North Dakota Bankers Association, Ohio Bankers Association, Pennsylvania Bankers Association, and the Texas Bankers Association submit this brief as *amici curiae* in support of Petitioner, the William L. Rudkin Testamentary Trusts.

## INTEREST OF AMICI CURIAE

The ABA is the largest national trade association of the banking industry in the country. It represents banks and holding companies of all sizes in each of the fifty states and the District of Columbia, including community, regional, and money center banks. The ABA also represents savings associations, trust companies, and savings banks. ABA members hold approximately 95% of the U.S. banking industry's domestic assets. ABA frequently appears in litigation, either as a party or *amicus curiae*, in order to protect and promote the interests of the banking industry and its members.

Also appearing as *amici* are eleven state bankers associations ("State Association *Amici*"). The State Association *Amici* represent the interests of their members (which include state and federally chartered banks, as well as savings and loan associations) at the state and local levels. They provide a voice for the industry in their respective state legislatures, and support to their members with research and information, public relations, continuing professional education and educational materials, and business development.

The *amici* have a direct interest in the outcome of this litigation. Many of ABA's and the State Association *Amici's* members serve as trustees and executors, or act as agents for individuals who serve as executors or trustees. The issue

presently before the Court concerns the proper construction and interpretation of Section 67(e) of the *Internal Revenue Code* (the "Tax Code"), 26 U.S.C. § 67(e). This statute addresses the taxation of trusts and estates, specifically the deductibility of investment advisory fees. The outcome of this case will have a direct effect upon the manner in which the *amici's* members engage in (and are taxed on) their trust business.

## SUMMARY OF THE ARGUMENT

The ABA and the State Association *Amici* respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities, including a duty to prudently manage the trust that is in their care. This legal duty of prudence is embodied and codified in the Uniform Prudent Investor Act ("UPIA"). Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 44 states and the District of Columbia as the standard for trust investment law. It is the existence of this duty that differentiates the individual investor from the trustee; because trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help.

## ARGUMENT

At issue in this case is whether investment management fees incurred by trustees in carrying out their duties may be fully deducted against the gross income of a trust estate, or whether the expenses may be deducted only to the extent that they exceed 2 percent of adjusted gross income. Section 67(e) of the Tax Code, 26 U.S.C. § 67(e), generally provides that "miscellaneous itemized deductions for any taxable year" are deducted only to the extent "that the aggregate of such deductions exceeds 2 percent of adjusted gross income" of the estate. However, the text of 26 U.S.C. § 67(e) also creates an exception allowing for deduction of trust expenditures without regard to the two-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. 26 U.S.C. § 67(e)(1). Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

The Internal Revenue Service ("IRS") takes the position that, because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the taxpayer could not show that they would not have been incurred if the assets were not held in trust. The Service's position[2] has been the subject of litigation

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[2] It is worth noting that the Commissioner opposed review of this case partly on the grounds that the IRS was intending to issue a notice of proposed rulemaking regarding the deductibility of investment advisor fees. The IRS took the position that once the regulations were issued, the matter would be resolved because the court would be *required* to defer to the agency's interpretation of section 67(e) under *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984). The IRS has subsequently issued a notice of proposed rulemaking (...continued)

(including this case), producing varying outcomes. The Sixth Circuit in *O'Neill v. Commissioner*, 994 F. 2d 302 (6th Cir. 1993), concluded that investment management fees are fully deductible by trusts because they "would not have been incurred if the property had not been held in trust."[3] The Federal Circuit[4] and Fourth Circuit[5] have previously reached the opposite result, each holding that Section 67(e) of the Tax Code does not permit the full deduction of investment management fees because these expenses are commonly incurred outside of the trust context. Finally, in the decision below, the Second Circuit advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner."[6] Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits,[7] the Second Circuit held that

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(...continued)
that seeks comment on proposed regulations that address the issue before the court. See *Section 67 Limitations on Estates or Trusts*, 72 Fed. Reg. 41243 (July 27, 2007). The *amici* respectfully submit that, apart from the rather curious timing, the IRS's proposed regulations are irrelevant to the court's consideration of this case. The notice of proposed rulemaking was issued by the IRS well *after* the operative facts of this case occurred, and no final regulations have been issued. Further, the Court need not defer to the IRS's interpretation of the law contained in its final regulation – whenever it is issued and in whatever form it eventually takes – if that interpretation is contrary to the express language of the statute or the regulations are arbitrary and capricious.

[3] *O'Neill*, at 304.

[4] *Mellon Bank, N.A. v. United States*, 265 F. 3d 1275, 1281 (Fed. Cir. 2001).

[5] *Scott v. United States*, 328 F. 3d 132, 140 (4th Cir. 2003).

[6] *William L. Rudkin Testamentary Trust v. Commisioner of Internal Revenue*, 467 F.3d 149, 160 (2nd Cir. 2006).

[7] *Id.*

fees paid by trusts and estates for management and investment of assets are never fully deductible - a conclusion that the *amici* believe is incorrect.

The ABA and the State Association *Amici* respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities.

It is the existence of this legal duty of prudence that differentiates the individual investor from the trustee. Trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help. Unlike trustees, individual investors are

> not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

*O'Neill*, 994 F.2d at 304. The Sixth Circuit found persuasive the existence of a legal duty to potentially seek out and incur costs for investment advice when it concluded that investment management fees are fully deductible under

Section 67(e) of the Tax Code since they "would not have been incurred if the property had not been held in trust."[8]

This legal duty of prudence has been embodied and codified in the UPIA. Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 44 and the District of Columbia as the standard for trust investment law.[9]

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[8] *O'Neill,* at 304.

[9] Alaska Stat. §§ 13.36.225 – 13.36.290 (West, Westlaw through 2006 Sess.); Ariz. Rev. Stat. Ann. §§ 14-7601 – 14-7611 (West, Westlaw through June 20, 2007); Ark. Code Ann. §§ 24-2-610 – 24-2-619 (West, Westlaw through 2006 Sess.); Cal. Prob. Code §§ 16045 – 16054 (West, Westlaw through 2007 Sess.); Colo. Rev. Stat. Ann. §§ 15-1.1-101 – 15-1.1-115 (West, Westlaw through July 1, 2007 Sess.); Conn. Gen. Stat. Sec. 45a-541-45a-541*l* (West, Westlaw through June 6, 2007); D.C. Code Ann. §§ 19-1309.01 – 19-1309.09 (West, Westlaw through June 11, 2007); Fla. Stat. Ann. §§ 518.11 (West, Westlaw through June 8, 2007); Haw. Rev. Stat. §§ 554C-1 – 554C-12 (West, Westlaw through 2006 Sess.); Idaho Code §§ 68-501 – 68-514 (West, Westlaw through 2007 First Sess.); Ill. Ann. Stat. ch. 760, para. 5/5, 5/5.1 (West, Westlaw through 2007 Sess.); Ind. Code Ann. §§ 30-4-3.5-1 – 30-4-3.5-13 (West, Westlaw through 2007 First Sess.); Iowa Code Ann. §§ 633.4301 – 633.4309 (West, Westlaw through 2007 First Sess.); Kan. Stat. Ann. §§ 58-24a01 – 58-24a19 (West, Westlaw through 2006 Sess.); Me. Rev. Stat. Ann. tit. 18-B §§ 901 – 908 (West, Westlaw through 2007 First Sess.); Md. Code Ann., Est. & Trusts §§ 14-405(c), 15-114(b) West, Westlaw through July 1, 2007 2005 Sess.); Mass. Gen. L. A. 203C, §§ 1 – 11 (West, Westlaw through 2007 First Sess.); Mich. Comp. Laws §§ 700.1501 – 700.1512 (West, Westlaw
(...continued)

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through 2007 Sess.); Minn. Stat. Ann. §§ 501B.151, 501B.152 (West, Westlaw through May 22, 2007 Sess.); Mo. Ann. Stat. §§ 469.900 – 469.913 (West, Westlaw through July 13, 2007 Sess.); Mont. Code Ann. § 72-34-601 – 72-34-610 (West, Westlaw through 2005 Sess.); Neb. Rev. Stat. §§ 30-3883 – 30-3889 (West, Westlaw through 2006 Second Sess.); N.Y. E.P.T.L. § 11-2.3 (West, Westlaw through 2007 Sess.); Nev. Rev. Stat. §§ 164.705 – 164.775 (West, Westlaw through 2006 Sess.); N.H. Rev. Stat. Ann. §§ 564-B:9-901 – 564-B:9-906 (West, Westlaw through July 30, 2007); N.J. Stat. Ann. §§ 3B:20-11.1 – 3B:20-11.12 (West, Westlaw through 2007 Sess.); N.M. Stat. Ann. §§ 45-7-601 – 45-7-612 (West, Westlaw through June 28, 2007 Sess.); N.C. Gen. Stat. Ann. §§36C-9-901 – 36C-9-907 (West, Westlaw through 2007 Sess.); N.D. Cent. Code §§ 59-02-08.1 – 59-02-08.11 (West, Westlaw through 2005 Sess.); Ohio Rev. Code §§ 5809.01 – 5809.08 (West, Westlaw through 2005 Sess.); Okla. Stat. Ann. tit. 60 §§ 175.60 – 175.72 (West, Westlaw through July 31, 2007 Sess.); Or. Rev. Stat. §§ 130.750 – 130.755 (West, Westlaw through 2005 Sess.); 20 Pa. Cons. Sta. Ann. §§ 7201 – 7214 (West, Westlaw through 2006-189); R.I. Gen. Laws §§ 18-15-1 – 18-15-13 (West, Westlaw through 2006 Sess.); S.C. Code Ann. § 62-7-933 (West, Westlaw through 2006 Sess.); S.D. Codified Laws Ann. §§ 55-5-6 – 55-5-16 (West, Westlaw through 2007 Sess.); Tenn. Code Ann. §§ 35-14-101 – 35-14-114 (West, Westlaw through 2007 First Sess.); Tex. Prop. Code Ann. §§ 117.001 – 117.012 (West, Westlaw through 2007 Sess.); Utah Code. Ann. §75-7-901 – 75-7-907 (West, Westlaw through 2007 Sess.); Vt. Stat. Ann. tit. 9, §§ 4651 – 4662 (West, Westlaw through 2007 First Sess.); Va. Code Ann. §§ 26-45.3 – 26-45-14 (West, Westlaw through 2007 Sess.); Wash. Rev. Code Ann. §§ 11.100.010 – 11.100.140 (West, Westlaw through 2007 Sess.); W. Va. Code §§ 44-6C-
(...continued)

The UPIA provides, in part that a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[10] These "other circumstances" that a trustee must take into consideration when executing this duty as a "prudent investor" include:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; and
- the expected total return from income and the appreciation of capital.[11]

A prudent trustee must consider a trust portfolio as a whole, with an emphasis on what the commentary to the UPIA refers to as "the main theme of modern investment practice, sensitivity to the risk/return curve."[12] A trustee must also consider the "other resources" of the beneficiaries; the beneficiary's needs for liquidity; regularity of income, preservation or appreciation of capital; and an asset's special

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(...continued)

1 – 44-6C-15 (West, Westlaw through 2007 First Sess.); Wis. Stat. Ann. § 881.01 (West, Westlaw through 2007 Act 18); Wyo. Stat. Ann. §§ 4-10-901 – 4-10-913 (West, Westlaw through 2007 Sess.).

[10] UPIA, Section 2(a).

[11] UPIA, Section 2(c).

[12] UPIA, Section 2, Comment on Risk and return.

relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[13]

The UPIA's approach to trust management presents a marked change from many older statutes that allowed a trustee to simply rely on lists of "approved" investments. The commentary to the UPIA observes that the "universe of investment products changes incessantly."[14] The UPIA's commentary cites the fact that equities and futures were at one time thought to be too risky as one example of this "incessant" change in acceptable investment products.[15] Both are now used in fiduciary portfolios. On the other hand, long-term bonds, once a model trust investment, may be seen as posing their own risks.[16]

Moreover, the requirements of the UPIA itself can make the trust manager's task of prudently investing and managing trust assets complex. Section 3 of the UPIA requires that a "trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[17] At the same time, a strategy that minimizes the taxation incident to portfolio turnover is preferred.[18] A trustee is also required to make a reasonable effort to verify facts relevant to the investment and

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[13] UPIA, Section 2(c).

[14] UPIA, Section 2, Comment on abrogating categorical restrictions.

[15] UPIA, Section 2, Comment.

[16] UPIA, Section 2, Comment.

[17] UPIA, Section 3.

[18] UPIA, Section 3, Comment.

management of trust assets.[19] Prudent diversification and proper asset allocation may well include investments in asset classes other than high-quality bonds and large capitalization stocks. Trustees may find it necessary to invest in a far broader array of assets including international stocks, international bonds, small capitalization stocks, real estate, timber, venture capital funds, hedge funds or high-yield bonds. In some (but not necessarily all) instances, a trustee simply may not have the expertise at hand to prudently make these investments, compelling them to embrace an "open architecture" strategy employing one or more third party investment specialists.

Many trustees or fiduciaries would find it daunting – or irresponsible – to take on the complex duty of administering a trust without the help of professional investment assistance. In such cases, the legal duty to act as a "prudent investor" would dictate that a trustee hire one or more investment managers to handle the complexities inherent in modern trust management. Indeed, the drafters of the UPIA anticipated that a prudent trustee will choose to hire an investment manager or seek professional advice in order to ensure the proper management of the assets, and that such a delegation will often benefit the trust beneficiaries.

In sum, the Court should conclude that the Second Circuit decided the case below incorrectly. The existence of a legal duty of prudence differentiates the individual investor from the trustee, and the fulfillment of that duty of prudence may require a trustee to retain expert investment help. The advice received by the trustee (and for which the fees are incurred) is in most cases peculiar to the particular trust in light of the trust's purpose and other factors outlined by the

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[19] UPIA, Section 2, Comment.

UPIA. The Court should ultimately conclude that investment management fees are fully deductible by trusts under Section 67(e) of the Tax Code because they "would not have been incurred if the property had not been held in trust."

## CONCLUSION

Based upon the foregoing, the ABA and State Association *Amici* urge the Court to grant the petition for certiorari to resolve the conflict between the circuits and to provide a uniform interpretation of the Tax Code.

Respectfully submitted,

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IN THE

# Supreme Court of the United States

MICHAEL J. KNIGHT,
Trustee of the William L. Rudkin Testamentary Trust,

*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

## BRIEF OF AMICUS CURIAE OF THE TAX SECTION OF THE FLORIDA BAR IN SUPPORT OF PETITIONER


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## QUESTION PRESENTED

Whether investment advisory expenses incurred by a trustee in the administration of a trust are subject to the limitation on deductibility of miscellaneous itemized deductions under I.R.C. § 67(a), commonly referred to as the "2% Floor," or excepted from this limitation by reason of I.R.C. § 67(e)(1).

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## INTEREST OF AMICUS CURIAE

The Tax Section of The Florida Bar (the "Tax Section") is a section of The Florida Bar with a mission to serve and support members and the community by: (i) furthering the tax knowledge and practice of interested members of The Florida Bar in federal and state tax law; (ii) developing standards for ethical and competent practice of tax law by lawyers; (iii) developing and maintaining proper professional relationships between tax lawyers, nonlawyer groups and other lawyer groups; and (iv) improving the operation of the federal and state tax laws, rules and regulations, to accomplish legitimate legislative objectives and to improve the administration of tax law. It is with the intent to improve and accomplish legitimate operation of the tax law that we file this Amicus Brief.[1]

The Tax Section strives to protect and assist the public to ensure proper application of the federal tax laws including the income taxation of trusts and estates. According to the Florida Department of Health, Office of Vital Statistics, an estimated 170,300 Florida residents died in 2005. Florida Department of Health, Office of Vital Statistics, *Florida's Chart for Deaths of All Causes*, *http://*www.floridacharts.com/charts /DeathQuery.aspx (accessed July 27, 2007). An estate (and one or more trusts) is frequently created as a result of these deaths. In addition, there are many inter vivos and testamentary trusts currently being administered and more created each year. In virtually all cases, a fiduciary is appointed to administer the property held in an estate or trust. A fiduciary does not own the assets of the estate or trust personally. Rather, a fiduciary administers those assets for the benefit of others, subject to substantial fiduciary obligations under State law. It has been said that a trustee must

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1. The parties have consented to the filing of this brief and letters of consent have been filed with the Clerk. In addition, pursuant to Supreme Court Rule 37.6, the Tax Section affirms that no party has written this brief in whole or in part and that no person or entity, other than the amicus or its attorneys, has made a monetary contribution for the preparation or submission of this brief.

act with "a punctilio of an honor the most sensitive." *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928). To acquit his or her fiduciary obligations, a fiduciary will incur expenses and may be personally surcharged. Many of those expenses are necessary to the proper administration of the estate or trust under State law and are incurred in response to specific fiduciary duties imposed under the law. *Bingham's Trust v. CIR*, 325 U.S. 365 (1945) (after considering the proximate relationship between expenses incurred and property held by the trust, a deduction was allowed for legal expenses concerning taxation of current distribution of appreciated property).

The specific issue presented in this case is whether investment advisory expenses incurred by a trustee in the administration of a trust[2] are subject to the limitation on deductibility of miscellaneous itemized deductions under I.R.C. § 67(a), commonly referred to as the "2% Floor," or excepted from this limitation by reason of I.R.C. § 67(e). This Court's decision on the proper construction of I.R.C. § 67(e) in this case will determine the extent to which investment advisory expenses incurred by fiduciaries are deductible "above the line" or "below the line." Therefore, as a friend of the Court, the Tax Section is interested in submitting an analysis and assisting the Court in interpreting I.R.C. § 67(e) due to the significant impact on trusts and estates, particularly in Florida.

## SUMMARY OF THE ARGUMENT

I.R.C. § 67(a), enacted by the Tax Reform Act of 1986, *See* Tax Reform Act, *Pub. L. No. 99-514, 100 Stat. 2085, § 132(a)*, provides that miscellaneous itemized income tax deductions are allowed only to the extent that the aggregate of such deductions exceeds 2% of the taxpayer's adjusted gross

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2. The present case involves a trust. However, I.R.C. § 67(e) applies to trusts and estates. For ease of reference, when we refer to "trustee" we mean to include trustees, executors and personal representatives and when we refer to "trust" we mean to include both trusts (specifically non-grantor trusts) and estates.

income.[3] This limitation applies to individuals, estates and trusts. *I.R.C. § 67(a), (b); See also Treas. Reg. § 1.67-1T(a)(1) (The deductions limited by the 2% Floor are commonly referred to as below-the-line deductions).* However, I.R.C. § 67(e) provides that the 2% Floor does not apply to costs paid in connection with trust administration which would not have been paid if property were not held in trust. Amicus urges this court to determine the meaning of the "which would not have been incurred" language in the second prong of I.R.C. § 67(e)(1) to require a proximate relation between the cost incurred and the fiduciary obligation of the trustee. In determining the meaning of such language, we have analyzed the language of the Internal Revenue Code ("Code"), judicial precedent, legislative history and the unique nature of trusts[4] in general.

The language of I.R.C. § 67(e) does not elaborate on the meaning of the "which would not have been incurred" language of I.R.C. § 67(e)(1). However, with respect to investment advisory expenses, other sections of the Code, including I.R.C. §§ 212, 2053, suggest that investment advisory expenses of trusts should be deducted in full and not subject to the 2% Floor because such fees are incurred i.e., in the fiduciary context.

The Circuit Courts have been unable to construe I.R.C. § 67(e)(1) consistently; however, each court understood the "would not have been incurred" language of I.R.C.§ 67(e)(1) to

3. "Adjusted gross income" is defined in I.R.C. § 62. Certain itemized deductions and other expenses are deducted from gross income, defined in I.R.C. § 61, to determine adjusted gross income. Other itemized deductions and expenses are deducted from a taxpayer's adjusted gross income to determine the taxpayer's taxable income against which the income tax under I.R.C. § 1 is imposed. Deductions allowed in determining adjusted gross income, along with the twelve items specified in I.R.C. § 67(b), are not subject to the 2% Floor.

4. The present case involves a trust. However, I.R.C. § 67(e) applies to trusts and estates. For ease of reference, when we refer to "trustee" we mean to include trustees, executors and personal representatives and when we refer to "trust" we mean to include both trusts (specifically non-grantor trusts) and estates.

require a connection between the cost incurred and the fiduciary relationship. The Sixth Circuit accurately recognized the fiduciary relationship between trustees and trust property and linked the "would not have been incurred" language of I.R.C. § 67(e)(1) to the fiduciary relationship of trustees and trust property.

A review of the legislative history reveals that the intended purpose of the "which would not have been incurred" language was to prevent the use of pass-through entities to circumvent the 2% Floor. The legislative history does not support the contention that Congress intended to deny a deduction for investment advisory expenses incurred by trustees in connection with acquitting their fiduciary obligations.

Meaningful interpretation of the "would not have been incurred" language of I.R.C. § 67(e)(1) is rooted in understanding the fiduciary relationship between trustees and trust property. Trustees differ fundamentally from individuals in their relationship to the property they are investing. Trustees are obligated, in most jurisdictions, to prudently invest the trust assets as part of the trustee's fiduciary obligations to the trust property and beneficiaries. Failure to prudently invest the trust assets may subject the fiduciary to personal liability, an exposure not experienced by an individual investing his or her own assets. Expenses incurred in furtherance of this fiduciary relationship would not be incurred outside the trust context. Regarding the investment advisory expenses at issue in this case, a trustee incurs these fees only in the context of carrying out the duties that the trustee has to the beneficiaries with respect to the trust assets. As a result, investment advisory expenses incurred by a trustee always have a relation to the trustee's fiduciary duties and obligations. Because of the fiduciary relationship between the trustee and trust property, investment advisory expenses incurred in the administration of a trust should be deductible in full under I.R.C. § 67(e)(1) without regard to the 2% Floor.

## ARGUMENT

### A. The Interpretation of the Limiting Language in I.R.C. § 67(e)(1) Should be Informed by, and Consistent with I.R.C. § 212.

I.R.C. § 212 provides a deduction to individuals for all the ordinary and necessary expenses paid or incurred during the taxable year for any of the following: (i) the production or collection of income, (ii) the management, conservation, or maintenance of property held for the production of income, or (iii) in connection with the determination, collection, or refund of any tax. I.R.C. § 212. Although I.R.C. § 212 provides a deduction to individuals for the expenses described above, such deductions are limited and allowed only to the extent that the aggregate of such deductions exceeds the 2% Floor. I.R.C. § 67(e) extends this limitation to trusts by providing that the adjusted gross income of a trust is computed in the same manner as in the case of an individual. I.R.C. § 67(e). However, I.R.C. § 67(e)(1) provides that certain deductions of trusts will not be limited by the 2% Floor, including the "deductions for the costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." I.R.C. § 67(e)(1).[5]

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5. On July 26, 2007, the United States Treasury Department filed in the Federal Register a notice of proposed rulemaking which contains proposed regulations that "provide guidance on which costs incurred by trusts are subject to the 2% floor for miscellaneous itemized deductions under I.R.C. § 67(a)." Federal Register, *Section 67 Limitations on Estates or Trusts*, Vol. 72, No. 144, Friday, July 27, 2007, p. 41243. The proposed regulations provide that costs incurred by trusts that are unique to a trust are not subject to the 2% floor. For this purpose, a cost is unique to a trust if an individual could not have incurred that cost in connection with property not held in a trust. Furthermore, the proposed regulations provide that services for the custody or management of property and advice on investing for total return are not unique. According to the Notice, the regulations, as proposed, apply to

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This exception to the 2% Floor recognizes that a trustee has a different relationship to the trust property than an individual has with their own personal assets. Specifically, a trustee may incur costs in connection with the fiduciary relationship inherent in trust administration. The expenses of a trustee that are a product of their fiduciary obligations should not be subject to the 2% Floor. Therefore, in order to escape application of the 2% Floor, I.R.C. § 67(e)(1) requires a nexus between the fiduciary relationship and the cost incurred by stating that the cost incurred must be one "which would not have been incurred" if the property were not held in trust. The critical question presented is what exactly is that nexus.

I.R.C. § 212 provides individuals, trusts and estates with a deduction for expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. I.R.C. § 212. The Treasury Regulations further provide that fees of investment counsel and similar expenses paid or incurred by a taxpayer in connection with investments held by such taxpayer are deductible under I.R.C. § 212 only if:

> (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by the taxpayer for the production of income, and (2) they are ordinary and necessary under all the circumstances, having regard to the type of

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payments made after the date final regulations are published in the Federal Register. Therefore, the proposed regulations do not apply to the case at bar. Nonetheless, the U.S. Supreme Court's decision in the case at bar can determine whether any such regulation is valid. In any event, even if the "would not" limitation contained in I.R.C. § 67(e)(1) is construed as "could not" as the Second Circuit and these proposed regulations do, it is contended, as discussed in the text of this brief, that an individual could not incur the expenses that a trust properly incurs because the individual is not acting pursuant to a fiduciary relationship as is a trustee.

> investment and the relation of the taxpayer to such investment.

*See* Treas. Reg. § 1.212-1(g). The first condition merely requires the investment advisory expenses be connected to the income or investments of the taxpayer. The second condition requires the investment advisory expenses be ordinary and necessary in the context of the type of investment and the relation of the taxpayer to the investment. Expenses are "ordinary and necessary" if such expenses are reasonable in amount and bear a reasonable and "*proximate relation* to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income" (emphasis added). Treas. Reg. § 1.212-1(d).

Importantly, I.R.C. § 212 does not require that the investment advisory expenses be "necessary" to the production or collection of income or the maintenance, conservation or management of property in a "but for" sense. Rather, I.R.C. § 212, as interpreted by the Treasury Regulations, requires only a "proximate relation" between the two. Treas. Reg. § 1.212-1(d). Similarly, I.R.C. § 67(e)(1) requires a connection between the cost incurred and the administration of a trust by stating that the cost must be one that "would not have been incurred" if the property were not held in such trust. When the issue is the deductibility of investment advisory expenses, Amicus submits that the interpretation of this limiting language in I.R.C. § 67(e)(1) should be informed by, and consistent with, I.R.C. § 212, its parent statute. Therefore, the interpretation of I.R.C. § 67(e)(1) also mandates a "proximate relation" between the investment advisory expenses and the administration of the particular trust in question.

Individuals are free to invest however they choose and have no obligation to invest in a prudent manner when they manage their own assets. On the other hand, trustees have a fiduciary obligation to prudently invest consistent with substantial fiduciary duties imposed under state law. Fla. Stat. § 518.11 (2007). The essence of a fiduciary relationship is that a fiduciary holds, manages and controls property for the benefit of others. Therefore, fiduciaries are accountable in a way that individuals

are not for the consequences of the investment decisions that they make, and are personally liable to the beneficiaries for failing to properly acquit that most fundamental of fiduciary duties. Restatement (Third) of Trusts §§ 90, 91 (2007). In addition, a fiduciary must invest the assets under the fiduciary's control in a manner consistent with the obligations imposed on the fiduciary by the terms of the governing instrument under which the fiduciary acts, be it a will or a trust agreement. *Id.* The duration of the fiduciary relationship, the objectives of the testator or settlor as set forth in the will or trust, and the identity of the beneficiaries are among the many factors that a fiduciary must consider when a fiduciary determines the appropriate investment policy for the assets under the fiduciary's control. An individual is not required to take such factors into account.

The unique nature of the particular fiduciary relationship will formulate the investment policy that a fiduciary determines to be appropriate. If the fiduciary determines to engage independent investment advisors thereby incurring investment advisory expenses, the investment advisor must in turn take into account the restrictions imposed by the fiduciary relationship.[6] Accordingly, the investment advice rendered will bear a proximate relation to the fiduciary obligations imposed by specific requirements of the particular trust. That proximate relation between incurring the costs of investment advisory expenses and the duties imposed on the trustee by State law and the terms of the will or trust satisfies the requirement of I.R.C. § 67(e)(1) that the particular cost would not have been incurred if the property were not held in trust. Therefore, investment advisory expenses paid in the fiduciary context by trustees, being informed by and therefore proximately related to the fiduciary relationship, are not subject to the 2% Floor.

6. Indeed, under the laws of most States, if a fiduciary is authorized to delegate investment decisions to an investment advisor, the investment advisor becomes accountable to the beneficiaries of the estate or trust as a fiduciary, and submits to jurisdiction in the place where the estate or trust is being administered for purposes of lawsuits by beneficiaries. Fla. Stat. § 518.112 (2007).

This construction of I.R.C. § 67(e)(1) is consistent with the plain meaning of the statute, the manner in which trusts are taxed generally under the Code, the legislative history and sound tax policy. Amicus further submits that it is the only construction susceptible of reasonable administration without unduly burdening fiduciaries with hair-splitting allocations of costs incurred in connection with the administration of a trust in a manner never intended by, and nowhere else present in, the Code.

### B. Though Circuit Courts Interpret I.R.C. § 67(e)(1) Inconsistently; Each Reviewing Circuit has Read the "Would Not Have Been Incurred" Language of I.R.C. § 67(e)(1) to Require a Connection Between the Cost Incurred and the Fiduciary Relationship.

In the present case, the Second Circuit found that the plain text of I.R.C. § 67(e) requires that fees are exempt from the 2% Floor only if they "*could not* have been incurred if the property were held by an individual" (emphasis added). *William L. Rudkin Testamentary Trust v. CIR*, 467 F.3d 149 (2d. Cir. 2006). If the Second Circuit's interpretation of I.R.C. § 67(e) is followed, the only expenses that would qualify for the exemption for trusts from the 2% Floor would be expenses an individual is incapable of incurring. In reality, there are no costs that a fiduciary might incur that an individual is incapable of incurring. This interpretation significantly narrows the plain meaning of the statute. As a result, the Second Circuit's holding would render all costs incurred in connection with the administration of an estate or trust subject to the 2% Floor. Not only does this holding rewrite the face of the statute, but it also varies greatly from the holdings in other Circuits that have considered this same issue.

In *O'Neill v. Commissioner v. CIR*, 994 F.2d 302, 303 (6th Cir. 1993), the co-trustees for the William J. O'Neill, Jr. Irrevocable Trust hired investment advisors to manage and invest the over $4.5 Million in assets held by the trust. The custodian of the trust deducted (above the line) the entire amount incurred

by the trust for the investment advisory expenses. *Id.* However, the Internal Revenue Service claimed that the investment advisory expenses were subject to the 2% Floor of I.R.C. § 67(a) and not excepted under I.R.C. § 67(e). *Id.* The Sixth Circuit stated that "certain expenditures unique to trust administration are excepted from the 2% floor." *Id.* at 303. The Sixth Circuit acknowledged that fiduciaries "uniquely" occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust. *Id.* at 304. Individuals have no such obligation and suffer no penalties of potential liability if they act negligently for themselves. *Id.* The Sixth Circuit further recognized the unique relationship a fiduciary has to the assets that make the investment advisory expenses "*necessary*" within the meaning of I.R.C. § 67(e). *Id.* These fiduciary responsibilities distinguish investment advisory services when incurred on behalf of a trust as opposed to investment advisory services incurred on behalf of an individual investor. Based on this reasoning, the Sixth Circuit held that investment advisory expenses are not subject to the 2% Floor of I.R.C. § 67(a) because they are exempted under I.R.C. § 67(e). *Id.*

In *Mellon Bank v. U.S.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001), the appellant argued that the expenses incurred for investment advisory services were necessary to fulfill its fiduciary obligations under State law. The U.S. Federal Circuit ("*Federal Circuit*") rejected the appellant's argument, because, in the court's opinion, it would render the second prong of the I.R.C. § 67(e) test superfluous. The court reasoned that since all fiduciary services are a requirement under State law, no fiduciary expense would be subject to the 2% Floor. *Id.* at 1281. The court listed expenses that would be fully deductible under I.R.C. § 67(e), *Mellon Bank*, 265 F.3d at 1281, including: fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax

returns.[7] Accordingly, the court held that the second prong of I.R.C. § 67(e) treats as fully deductible only those trust-related administrative expenses that are unique to the administration of trusts and not customarily incurred outside of trusts. *Id.*

Similarly, the Fifth Circuit held in *Scott v. U.S.*, 328 F.3d 132, 139-40 (4th Cir. 2003), that expenses commonly incurred by an individual are not excepted by I.R.C. § 67(e). The Fifth Circuit reasoned that finding a trust's investment advice expenses deductible would lead to the conclusion that all trust-related administrative expenses could be attributed to a trustee's fiduciary duties, rendering the second clause of I.R.C. § 67(e)(1) meaningless. *Id.* at 140. Although the court acknowledged that trust-related administrative expenses "solely attributable" to a trustee's fiduciary duties are fully deductible, the Fifth Circuit ultimately held that investment advice expenses are subject to the 2% Floor because these expenses are "often incurred" by an individual taxpayer. *Id.*

The issue is therefore solely one of degree - how close a connection is required. The plain text of the statute construed in the context of the manner in which trusts and estates are generally taxed under the Code requires no more than a proximate relationship between the expense incurred and the obligations of the fiduciary under state law.

Requiring a "proximate relation" between the expenses and the trust property does not render the second prong of I.R.C. § 67(e) superfluous. Not all costs incurred by a fiduciary are proximately related to the fiduciary duties imposed under state law. A fiduciary may incur costs that are incidental to maintenance and custody of the assets held by the fiduciary. Examples include bank fees and maintenance fees for rental

7. Certainly, the costs associated with preparing and filing income tax returns are not "unique" expenses of a trust. However, the court chooses to distinguish the preparing and filing of income tax returns in the context of a fiduciary as opposed to an individual. Similarly, we believe the costs of fiduciary investment advice should be distinguished from personal investment advice.

real estate. Those fees would be incurred regardless of who owned the property, and regardless of the specific duties owed by the fiduciary. Such incidental costs would be subject to the 2% Floor. Accordingly, the costs incurred by a fiduciary as a consequence of the fiduciary duties imposed under state law do not subsume all costs incurred by a fiduciary. Interpreting I.R.C. § 67(e) to permit the deduction of costs proximately related to complying with a fiduciary's fiduciary duties would render the limiting language of I.R.C. § 67(e) neither superfluous nor all encompassing, but rather strike an appropriate balance by permitting only costs proximately related to the duties of the fiduciary to be fully deductible.

### C. Legislative History Does Not Support the Contention that Congress Intended to Deny a Deduction for Investment Advisory Expenses Incurred by Trustees in Connection with Satisfying Their Fiduciary Obligations.

Amicus believes that the plain meaning of I.R.C. § 67(e) can be derived from the text itself when construed in the context of other parts of the I.R.C. closely related to it, including I.R.C. § 212 previously discussed, and I.R.C. § 2053 addressing the deduction of administration expenses in the context of an estate. When the meaning of a statute can be derived from the text itself, there is no need to examine its legislative history. *See Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 520 U.S. 1, 6 (2000) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (quotation omitted)). However, at least one Circuit Court found it appropriate to examine the legislative history relating to I.R.C. § 67(e). *Mellon Bank*, 265 F.3d at 1281. Because Amicus believes that Court to have incorrectly determined its import, it is appropriate to address that analysis here.

The interpretation of the legislative history by the Federal Circuit in *Mellon* is fundamentally flawed. Finding the overall purpose of the Tax Reform Act of 1986 was to "increase fairness, economic efficiency, and simplification of the tax system," the

Federal Circuit cited House Report 99-426 for the proposition that Congress was concerned taxpayers were able to "exclude or deduct from income certain items that differ little from items that are treated as taxable compensation or nondeductible expenditures for other taxpayers." *Id.* The analysis of the Federal Circuit further emphasized the intent of Congress to treat taxpayers similarly by maintaining a fair tax system. *Id.* The Federal Circuit then stated that the goal of Congress was "to eliminate or reduce the tax benefit of placing assets in a trust" by enacting the Tax Reform Act of 1986. *Id.*

After reciting this legislative history, the Federal Circuit concluded that, in order for Congress to reach this goal, there was not "a *significant* change in the taxation of trusts, but [that this goal was reached] through the application of the two percent floor rule to deductions from trust income" (emphasis added). *Id.* This conclusion is faulty as it ignores: (i) the text of the House and Senate bills, (ii) the second clause did not emerge until Conference Committee; (iii) the explanation provided in the General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation (the "Joint Committee Report") and (iv) the other *significant* changes to the taxation of trusts in the Tax Reform Act of 1986. *See* H.R. 3838, 99th Cong., 1st Sess., § 132 (as passed by the House, Dec. 17, 1985); H.R. 3838, 99th Cong., 2d Sess., § 133 (as passed by the Senate, June 24, 1986), *reprinted at* 132 Cong. Rec. 16,061, 16,070 (June 26, 1986), H.R.Rep. No. 99-841, vol II, at 34 (1986) (Conf.Rep.), *reprinted at* U.S.C.C.A.N. 4075, 4122. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987). The Federal Circuit's failure to acknowledge these issues led it to the erroneous conclusion, without support of legislative history, that the legislative intent was "to equate the taxation of trusts with the taxation of individuals."

The exception in I.R.C. § 67(e) for trusts from application of the 2% Floor was approved by the House and Senate in H.R. 3838 with no changes to the language as proposed.

*See* H.R. Rep. 99-426, at 109-110 (1985); S. Rep. 99-313, at 78-79. The language, as approved by the House and Senate, was to except from the floor "costs paid or incurred in connection with the administration of [an] estate or trust." *Id.* Thus, the second clause in I.R.C. § 67(e)(1) ("would not have been incurred if the property were not held in such trust or estate") was not included in the Tax Reform Act of 1986 until added by the Conference Committee. *See* H.R.Rep. No. 99-841, vol II, at 34 (1986) (Conf.Rep.), *reprinted at* US.C.C.A.N. 4075, 4122. However, a review of the Conference Committee Report does not clearly discuss the meaning of the additional language or reasons for the change. *Id.* The limiting language is merely referenced between a general statement about the application of the 2% Floor to pass-through entities (i.e., grantor trusts, partnerships, and S corporations) and a statement regarding regulations to be prescribed by Treasury relating to the reporting requirements necessary to effectuate the provision. Thus, the meaning of this second clause, as it relates to non-grantor trusts, is not readily apparent from a review of the House reports or Senate report relating to the enactment of I.R.C. § 67(e)(1).

When there is scarce legislative history to support the intended meaning of a statute, an analysis of the broader context in which the statute is adopted may be helpful. The Federal Circuit in *Mellon* correctly states that Congress intended to "increase fairness, economic efficiency, and simplification of the tax system" by the tax reform proposals submitted in House Report 3838. *See Mellon*, 265 F.3d at 1281. The application of a floor on employee business expenses and miscellaneous itemized deductions was among the many tax proposals submitted to Congress by President Reagan in 1985. *See* H.R. Rep. 99-426 (1985); S. Rep. 99-313. We agree with the Federal Circuit that the purpose was to "simplify" the tax system. However, the manner of achieving this goal was expressly stated in the Senate Finance Committee Report ("*Senate Report*"). Sen. Rep. No. 313, 99th Cong., 2nd Sess., pt. 1 (1986). The Senate Report states that the committee desired a simplified tax system

and sought to achieve this goal by replacing "more than a dozen tax rates" and placing restrictions on "personal deductions." *Id.* This does not correlate to placing restrictions on deductions when a trust is involved. As explained below, non-grantor trusts are treated for tax purposes as an entity separate from its owner. The goal of simplifying the tax system for individual taxpayers does not necessarily overlap with simplification of the system for an entity taxpayer, which by the nature of its existence cannot be taxed in the same manner as an individual. The Federal Circuit erred in assuming that the second clause in I.R.C. § 67(e)(1) was a way to "simplify" the tax system. The Senate Report clearly states that simplification was a goal for "*individuals* [that feared] the recordkeeping, paperwork, and computations necessitated by tax filing" (emphasis added). *Id.*

The Federal Circuit also accurately stated that the goal of the tax reform was to establish "fairness" in the system to ensure that individuals similarly situated were subject to the same tax liability. The Senate Report listed numerous ways in which "fairness" was sought including: (1) limiting the deduction for business meals; (2) severe limitations to deductions for attending investment seminars; (3) changes to employee eligibility for pension benefits; (4) elimination of the deduction for contributions to an IRA; (5) a substantial increase to the standard deduction to relieve many low-income families from tax liability; and (6) other means of creating fairness in the tax system. *Id.* There was no mention, however, that by limiting the exception for trusts from the 2% Floor that Congress intended to meet this goal of fairness. In fact, reading the second clause of I.R.C. § 67(e) as limiting the deductibility of investment expenses achieves a result quite opposite from fairness. Investment advisory expenses when incurred by a fiduciary are always proximately related to the fiduciary's duties under state law to invest prudently. An inequitable result is achieved when a cost is incurred to fulfill a fiduciary obligation, the cost therefore being by definition not personal in nature.

and yet a limitation aimed at preventing the deduction of personal expenses is imposed to preclude a full deduction.

Although "efficiency of the economy" was a goal of the 1986 tax reform, the legislative history is devoid of any language suggesting Congress believed limiting the exception for trusts from the 2% Floor would result in the intended efficiency. Incurring investment expenses has long been an ordinary and necessary activity of a trustee managing trust assets. A trustee should not attempt to gain the expertise or rely on their limited experience to conduct the trust's investment activities. Rather, a trustee should seek learned, sophisticated, and skilled investment advisors in order to obtain investment strategies and advice that take into account the specific fiduciary requirements of the trust or estate under administration. By interpreting the second prong of I.R.C. § 67(e)(1) as not allowing a full deduction for investment advisory expenses without regard to the 2% Floor, the Federal Circuit effectively encouraged inefficiency. Trustees that lack the requisite investment expertise are deterred from serving or, if they are unable to serve, seeking proper investment advice to perform their fiduciary duties.[8] Following the interpretation by the Federal Circuit, without any supportive legislative history, reaches a conclusion that is far from efficient for the industry or economy as a whole.

The assumptions reached by the Federal Circuit also overlooked the "reasons for change" expressly declared in Title I of the Joint Committee Report. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987) at 78. The Joint Committee Report acknowledged that miscellaneous itemized deductions "fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures." *Id.* Prior

8. Those trustees that are full-service trustees (a trustee that has investment expertise) are required to apportion their fees between investment advice and other trust administration. As such, there is no practical distinction on this issue between professional and non-professional trustees.

law resulted in "extensive recordkeeping with regard to what commonly are small expenditures" in order for taxpayers to deduct expenses. Congress wanted to strike a balance between taxpayers with small expenditures and other taxpayers with large expenditures having a significant impact on the individual's disposable income. *Id.* Additionally, Congress recognized the difficulty of the Internal Revenue Service to monitor and enforce deductions for such small amounts typically involved. By imposing the 2% Floor, Congress wanted to relieve the administrative burden for taxpayers as well as the Internal Revenue Service relating to these deductions. As stated in the Joint Committee Report, "Congress concluded that the imposition of the two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law." *Id.*

In contrast to *Mellon*, there is no reference in the legislative history that the exception provided for "estates and non-grantor trusts" was intended "to *equate* the taxation of trusts with the taxation of individuals" (emphasis added). *Mellon Bank*, 265 F.3d at 1281. If the goal of Congress was to "equate" trust taxation to that of an individual, Congress would not have provided for an exception at all. The exception in I.R.C. § 67(e)(1) harmonizes the 2% Floor with the general taxation of trusts as separate from the beneficial owner. Proper administration of a trust encompasses seeking legal counsel when necessary, performing ongoing accounting, tracking changes in the beneficial owners, maintaining records of all assets, as well as developing strategies and reviewing the investments to ensure proper investment management consistent with the fiduciary duties imposed under state law and the requirements of the governing instrument. So long as the fiduciary obligations are satisfied, ensuring proper investment management may either be: (i) conducted by the trustee; or (ii) obtained by an independent investment advisor. The legislative history is absent any language that would suggest

that Congress intended to deny a deduction for these expenses and effectively carve out this fiduciary obligation.

Although the legislative history does not support that the 2% Floor was a method of reducing the use of trusts for tax avoidance, there was a significant change in tax rates for trusts in the Tax Reform Act of 1986. I.R.C. § 1(e). In Title XIV of the Joint Committee Report, the "reasons for change" to the taxation of trusts was to prevent the "avoidance of tax." *General Explanation of the Tax Reform Act of 1986*, Joint Comm. on Taxation, JCS-10-87 (May 4, 1987) at 1245. Congress believed that "by revising the rate schedule applicable to trusts" that the benefits of using trusts are "significantly reduced." *Id.* The Act revised the rate schedule by taxing the first $5,000 of taxable income at 15% and any taxable income in excess of $5,000 at 28%. *Id.* The conclusion reached by *Mellon* ignores the "*significant*" compression of the tax brackets for trusts.

### D. I.R.C. § 67(e) Should be Interpreted to Allow Fiduciaries to Fully Deduct Expenses Proximately Related to the Trust Property, Including Investment Advisor Expenses, Incurred While Satisfying Their Required Fiduciary Obligations.

The legislative history clearly illustrates the intent of Congress to prohibit the use of pass-through entities[9] to avoid the 2% Floor. *Id.* at 78. However, Congress also intended to strike a careful balance between prohibiting the use of pass-through entities to circumvent the 2% Floor, and recognizing the unique tax and fiduciary circumstances concerning trustees.

Congress recognized the potential abuse of individuals using pass-through entities to avoid application of the 2% Floor

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9. Pass-through entities are entities that do not pay tax on income at the entity level. Examples of pass-through entities are partnerships, S corporations, and grantor trusts.

and enacted I.R.C. § 67(c).[10] The income and expenses of these entities is generally taxable or deductible by its partners and shareholders, respectively, and reported on their individual income tax returns. Therefore, it is appropriate that the individual owners are allowed to utilize deductions only to the extent such owner personally could have done so but for the existence of the pass-through entity. However, costs from pass-through entities cannot have a proximate relation to the duties of a fiduciary holding the pass-through interest because the fiduciary does not make the decision to incur them.

Grantor trusts[11] are another type of entity which cannot be used to avoid the application of the 2% Floor. Similar to a pass-through entity, a grantor trust is a special type of trust arrangement in which the grantor has a sufficient beneficial interest or has retained sufficient control that the grantor is treated as the owner of the trust assets for income tax purposes. Because of this imputed ownership, all items of income, deduction, and credit with respect to the trust assets are reported on the personal income tax return of the grantor. I.R.C. § 671. Therefore, the grantor's deductions relating to the trust must be limited by the 2% Floor.

In contrast, non-grantor trusts, such as the one at issue before this Court, differ fundamentally from other pass-through entities under the I.R.C. While partnerships, S corporations, and grantor trusts generally do not pay tax and pass all items of income to its owners, a non-grantor trust typically pays tax on income earned by the trust.[12]

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10. I.R.C. § 67(c)(1) of the I.R.C. directs the Secretary of the Treasury to enact regulations which prohibit "indirect deduction through pass-through entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual."

11. Grantor trusts are defined and governed by Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the I.R.C..

12. *See* I.R.C. § 641, *et. al.* To the extent that Distributable Net Income (as defined in I.R.C. § 643(a)) is not fully distributed to the

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Non-grantor trusts are generally not favorable entities for taxpayers to reduce income tax liability. Non-grantor trusts are subject to higher tax rates because of the compressed income tax brackets found in I.R.C. § 1(e). Because a non-grantor trust is a separate taxpayer, unlike other pass-through entities, deductions that cannot be taken at the trust level generally do not pass to the beneficiaries.[13] Instead, the deductions are potentially lost even if the trust's entire taxable income is distributed. Consequently, a trust can cause its beneficiaries to be subject to higher taxes than if they owned the property of the trust directly.

These characteristics of non-grantor trusts under the I.R.C. support the proposition that I.R.C. § 67(e) should not be interpreted as an additional safeguard against taxpayers abusing non-grantor trusts in an effort to reduce personal tax liability. For example, suppose a non-grantor trust has taxable income of $100,000 and deductions subject to the 2% Floor of $2,000. The trust distributes all its income to a beneficiary who has $100,000 of other taxable income and $4,000 of other deductions subject to the 2% Floor. Because $2,000 of deductions are lost at the trust level, none of the deductions may be taken. If the beneficiary could report all the income and deductions on her personal tax return, $2,000 of the total deductions of $6,000 would be available to offset the $200,000 of taxable income.

I.R.C. § 67(e) should be interpreted as a tool for fiduciaries to deduct expenses proximately related to the trust property (such as investment advisor expenses) that are incurred while

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trust beneficiaries, the trust itself will pay tax on that income. This is typical when a non-grantor trust does not require the trustee to distribute all of the trust income annually or gives the trustee the discretion to distribute as much income as it deems necessary (as is the case in the *William L. Rudkin Testamentary Trust u/w/o Henry A. Rudkin*).

13. *But see* I.R.C. § 642(h) of the I.R.C. (unused loss carryover and excess deductions are distributed to the trust beneficiaries in the year of termination).

satisfying their required fiduciary obligations. The trustee holds the trust principal for the benefit of the trust beneficiaries and, therefore, must manage the property appropriately. As a result of this relationship, local law often requires trustees to uphold certain obligations, such as the duties of good faith, loyalty and impartiality among the beneficiaries, and the duty to account. *See, e.g.*, Fla. Stat. §§ 736.0801-0803, 736.08135. These obligations do not apply to an individual managing his or her personal assets.

Importantly, most jurisdictions require the trustee to prudently invest the trust assets. *See, e.g.*, Fl. Stat. § 736.0901 and Uniform Law Commission, *A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-ss-upria.asp* (last accessed August 13, 2007). This "prudent investor rule" generally requires the trustee to invest trust property in a reasonable manner, balancing investment risk and return in the most economic manner possible, taking into consideration the trust purpose and its beneficiaries. *See* Uniform Law Commission, Summary of the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_summaries/ uniformacts-s-upia.asp (last accessed August 13, 2007). Some of the considerations a trustee must consider when investing trust property include general economic conditions, inflation or deflation, total return from income or the appreciation of capital, and the other resources of the beneficiaries. Most local laws also require the trustee to properly diversify trust assets. *Id.*

Expenses incurred by a fiduciary in that capacity are not merely for the purpose of enhancing the investment performance of the assets under his or her control but are part of a fiduciary's duty to manage the trust assets for the benefit of others, not for personal gain. These expenses incurred in furtherance of this fiduciary relationship "could not" be incurred by an individual who has no potential liability for breach of a fiduciary duty with respect to such assets.

Regarding the investment advisory expenses at issue in this case, a trustee must incur those fees while carrying out the duties that the trustee has to the beneficiaries with respect to the trust assets under his or her control. A trustee is concerned with the interests of all trust beneficiaries and with the obligations and duties required of a fiduciary under local law, such as the duty prudently to invest trust assets. Failure to invest trust assets prudently may well subject a trustee or executor to liability far in excess of any trustee or executor fees his or her services may generate. These matters do not concern an individual investing for personal gain.

As a result, investment advisory expenses incurred by a trustee always have a relation to the trustee's fiduciary duties and obligations. For that reason, investment advisory expenses incurred in the administration of an estate or trust should be deductible under I.R.C. § 67(e) without regard to the 2% Floor. This interpretation of I.R.C. § 67(e) upholds the delicate balance between preventing the use of pass-through entities to enhance the deduction of personal expenses and permitting fiduciaries to properly discharge their fiduciary obligations.

### E. I.R.C. § 67(e)(1) Requires a Connection Between the Cost Incurred and the Administration of a Trust by Stating that the Cost Must be One that "Would Not Have Been Incurred" if the Property Were Not Held in Such Trust.

Rules of statutory construction require that meaning be given to all words in a statute. *See Kawaauhau v. Geiger*, 523 U.S. 57, 62, 118 S. Ct. 974, 140 L. Ed. 2d 90 (1988) ("[W]e are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law."). These rules prevent the second prong of I.R.C. § 67(e)(1) as no more than repetition of the first prong of I.R.C. § 67(e)(1) to exempt all trust and estate administration costs from the 2% Floor. To give meaning to the second prong of I.R.C. § 67(e)(1), it must be read to create two categories of trust administration costs: those that are subject to the 2% Floor and those exempt

from it. The question is what administrative costs did Congress intend to exempt from the 2% Floor by using the phrase "would not have been incurred if the property were not held in such trust or estate."

In the present case, the cost at issue is the cost of investment advisory expenses. I.R.C. § 212 is the relevant section of the I.R.C. which provides for the deduction of investment advisory expenses and would therefore be useful in determining how the words of I.R.C. § 67(e)(1) should be construed with respect to investment advisory expenses. *See* I.R.C. § 212. In order for investment advisory expenses to be deductible under I.R.C. § 212, such fees must be "ordinary and necessary under all circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment." *See* I.R.C. § 212 and Treas. Reg. § 1.212-1(g). Investment advisory expenses are "ordinary and necessary" if such expenses are reasonable in amount and bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income. Treas. Reg. § 1.212-1(d). I.R.C. § 212, therefore, requires that investment advisory expenses bear a proximate relationship to the investment and be considered in context, having regard to the type of investment and the relationship of the taxpayer to such investment.

Upon making the determination that investment advisory expenses are deductible under I.R.C. § 212 by determining that such fees bear a proximate relationship to the investment and by considering the relationship of the taxpayer to the investment and the type of investment, a trustee must determine if the deduction is limited by I.R.C. § 67(e). Such determination depends on whether the investment advisory expenses would have been incurred if the property were not held in trust. In answering this question, three circuit courts have used the description of "unique" to identify the type of costs that would not be subject to the 2% Floor (i.e., costs that would not have been incurred if the property were not held in trust).

*O'Neill v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993); *Mellon Bank v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001); *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149, 153 (2nd Cir. 2006).

A cost is "unique" to the administration of a trust if such cost "would not have been incurred" if the property were not held in trust. The "unique" requirement of I.R.C. § 67(e)(1) should be read together with I.R.C. § 212 which requires that investment advisory expenses bear a proximate relationship to the investments, that the relationship of the taxpayer to the investment be considered, and that the type of investment be considered. Investment advisory expenses incurred in the context of a trustee and trust are "unique" because of the fiduciary context in which those fees are incurred.

Investment advisory expenses incurred in the context of a fiduciary relationship must, out of necessity, consider the fiduciary relationship. Any investment policy adopted by a trustee must consider the trustee's fiduciary duties to manage, invest and control assets for the benefit of the beneficiaries. Failure of the fiduciary to prudently invest trust assets may subject that fiduciary to personal liability, a liability not experienced by an individual investing his or her own assets. It is that fiduciary relationship and potential fiduciary liability that makes investment advisory expenses incurred in the context of trust administration "unique" as compared to investment advisory expenses incurred by an individual. Due to the nature of a trust and the responsibilities of a fiduciary, the costs incurred by trusts as a result of the fiduciary relationship are not and could not be personal in nature. In other words, the "fiduciary investment advisory expenses" would not be incurred if property were not held in trust and are therefore not subject to the 2% Floor.

This critical distinction between trust expenses incurred to fulfill fiduciary obligations (i.e., fiduciary investment advisory expenses) and those that are personal in nature (i.e., personal investment advisory expenses) has long been contained in the

tax law. Expenses to administer a decedent's estate, for example, are deductible under I.R.C. § 2053(a)[14] for estate tax purposes only if "actually and necessarily incurred in the administration of decedent's estate. Expenditures not essential to the property settlement of an estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions." Treas. Reg. § 20.2053-3(a). I.R.C. § 67(e) should be construed consistently with I.R.C. § 2053.

### F. I.R.C. §§ 67(e), 2053 Should be Construed Consistently.

In the context of the federal estate tax, I.R.C. § 2053 permits a deduction for administration expenses. I.R.C. § 2053(a). Thus, in a taxable estate, investment advisory expenses may be deducted in full for estate tax purposes. In the case of a nontaxable estate (for example, an estate with a surviving spouse where the unified credit and marital deduction combine to produce a zero estate tax), administration expenses are typically deducted on the estate's income tax return (as an income tax deduction) rather than the estate's estate tax return (as an estate tax deduction). Under current law, estate management expenses, which under Treas. Reg. § 20.2056(b)-4(b) expressly include investment advisory expenses, may be paid from the marital share of the estate without reducing the marital deduction. In other words, such expenses may be incurred and deducted for income tax purposes without any negative estate tax consequence, preserving a zero estate tax result because the marital deduction is not affected even though the expenses are charged against the marital share. However, if I.R.C. § 67(e) were construed, as Respondent proposes, when investment advisory expenses are deducted for income tax purposes, instead of being fully deductible as they would have been under I.R.C. § 2053 in the case of a taxable estate, they would become subject

14. I.R.C. § 2053(a) allows costs of administering certain property included in the decedent's gross estate but which is property not subject to claims of the decedent under local law subject to the time limitations contained in that section.

to the 2% Floor. Since the estate tax rate is higher than the income tax rate, this result creates a substantial inconsistency. A taxable estate receives a higher deduction against a higher tax, whereas a nontaxable estate receives a lower deduction against a lower tax. There is no policy justification for this anomaly.

### G. The "Would Not" Limitation Contained in I.R.C. § 67(e) Should be Limited to Expenses Not Proximately and Causally Incurred in Furtherance of a Fiduciary Duty.

The I.R.C. contains nearly fifty (50) itemized deductions.[15] Several of these may be incurred by an individual, on the one hand, or a fiduciary, on the other. It is those deductions at which the "would not" limitation contained in I.R.C. § 67(e) should be confined. For example, both an individual and a fiduciary may realize a loss on account of a bad debt described in I.R.C. § 166 which is allowable under that section as an itemized deduction. Unless incurred in a trade or business, such a bad debt would be subject to the 2% Floor of I.R.C. § 67(a). Such a bad debt is not incurred by a trust as a result of a causal relation to the fiduciary nature of the taxpayer. Therefore, this expense falls within the "would not" limitation of I.R.C. § 67(e).

Similarly, expenses made subject to the 2% Floor of I.R.C. § 67(a) through the application of the "pass through" rule of I.R.C. § 67(c) would apply to a fiduciary to the same extent that it applies to an individual because such expenses are not incurred by the fiduciary by reason of the proximate causal relationship to the trust. Hence, an expense passed through as a deduction to a trust as a partner in an investment partnership.

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15. I.R.C. § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than those listed in the section as excepted from the definition. I.R.C. § 68 does not use the phrase "miscellaneous itemized deductions" but rather "itemized deductions" although certain expenses are excluded under I.R.C. § 68(c) from the definition of itemized deduction for purposes of I.R.C. § 67(a). Twelve itemized deductions are excluded from the rule contained in I.R.C. § 67(a); three are excluded from the rule contained in I.R.C. § 68(a).

therefore, would be subject to the 2% Floor as it would if passed through to an individual partner.

## CONCLUSION

Despite the seemingly blanket coverage of the 2% Floor, I.R.C. § 67(e) excludes certain deductions for trusts from the 2% Floor. Specifically, this section provides, in part, that the 2% Floor does not apply to "the deductions for costs which are paid or incurred in connection with the administration of an estate or trust and *which would not have been incurred if the property were not held in such estate or trust.*" I.R.C. § 67(e)(1) (emphasis added). The language in I.R.C. § 67(e) should be interpreted consistently with other sections of the Code, particularly I.R.C. §§ 212, 2053. As a result, the second clause of I.R.C. § 67(e)(1) should be construed to require a "proximate relation" between the cost incurred and the fiduciary duties imposed under state law. The legislative history of the Tax Reform Act of 1986 does not support any intention of Congress to deny a full deduction when expenses are incurred by a trustee in connection with satisfying the trustee's fiduciary duties. Rather, the legislative history supports that the "would not have been incurred" language was intended to prevent the use of pass-through entities to avoid application of the 2% Floor. As recognized by the Sixth Circuit, expenses incurred by a fiduciary, in that capacity, are not merely for the purpose of enhancing the investment performance of the assets under his or her control but are part of a fiduciary's duty to manage the trust assets for the benefit of others. Therefore, investment advisory expenses incurred in the administration of a trust should be deductible under I.R.C. § 67(e)(1) without regard to the 2% Floor.

Respectfully submitted.

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